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Title: Bateman Eichler, Hill Richards, Incorporated, Petitioner
v.
Carl F. Berner, et al.

Court: United States Court of Appeals for the Ninth Circuit

Counsel for petitioner: Warren, Robert S.

Counsel for respondent: Solicitor General, Knudsen, Geoffrey P.

Entry	Date	Note	Proceedings and Orders
1	Oct 24 1984	G	Petition for writ of certiorari filed.
2	Nov 28 1984		DISTRIBUTED. January 4, 1985
3	Dec 3 1984	X	Brief of respondents Carl F. Berner, et al. in opposition filed.
4	Jan 7 1985		Petition GRANTED.
			**********
5	Feb 11 1985		Record filed.
6	Feb 11 1985		Certified copy of original record & C.A. proceedings, 3 volumes, received.
7	Feb 22 1985		Brief amicus curiae of Securities Industry Assn. filed.
8	Feb 25 1985	G	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
9	Mar 4 1985		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED. Justice Marshall and Justice Powell OUT.
10	Feb 25 1985		Joint appendix filed.
11	Feb 25 1985		Brief of petitioner Bateman Eichler, etc., Inc. filed.
12	Mar 15 1985		SET FOR ARGUMENT. Monday, April 15, 1985. (4th case).
13	Mar 22 1985		CIRCULATED.
14	Mar 27 1985	X	Brief amicus curiae of Securities and Exchange Commission filed.
15	Mar 27 1985	G	Motion of the Solicitor General to permit Bruce N. Kuhlik, Esquire, to present oral argument pro hac vice filed.
16	Apr 1 1985		Motion of the Solicitor General to permit Bruce N. Kuhlik, Esquire, to present oral argument pro hac vice GRANTED. Justice Marshall OUT.
17	Apr 1 1985	X	Brief of respondents Carl F. Berner, et al. filed.
18	Apr 8 1985	X	Reply brief of petitioner Bateman Eichler, etc., Inc. filed.
19	Apr 15 1985		ARGUED.

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No. ____

In the Supreme Court

OF THE

United States

OCTOBER TERM 1984

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED,
Petitioner,

vs.

CARL F. BERNER, et al.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED

1. Should the common law *in pari delicto* defense bar implied private actions under the federal securities laws by an admitted tippee-securities law violator against the alleged tipper because, as all of the reported decisions of the courts of appeal except that of the Ninth Circuit have concluded, (i) the defense implements a wise and historically proven policy of the common law against rewarding wrongdoers and (ii) preserves the integrity of the securities markets and the judicial process?

2. Should the *in pari delicto* defense bar federal securities law claims by an admitted tippee who actively pursued material inside information, traded upon it without disclosure in the public securities markets, and, under the Securities Exchange Act, behaved with at least the same degree of scienter as the alleged tipper-broker?

3. Should this Court endorse refusal to apply the *in pari delicto* defense in implied securities fraud actions based upon the concepts articulated in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), although *Perma Life* concerned expressly granted statutory antitrust actions and the defense of *in pari delicto* was limited for policy reasons absent in tippee versus tipper securities fraud suits?

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No. ____

In the Supreme Court

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OCTOBER TERM 1984

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED,
Petitioner,

VS.

CARL F. BERNER, et al.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Petitioner Bateman Eichler, Hill Richards, Incorporated ("BEHR"), one of the defendants in a securities fraud action below, respectfully prays that a writ of certiorari issue to review the order of the United States Court of Appeals for the Ninth Circuit entered in this proceeding on April 13, 1984 and modified on denial of rehearing on July 26, 1984. That order, *conflicting expressly with the decisions of all other courts of appeal confronted with the issue,* refused to allow the common law *in pari delicto* defense in a tippee versus tipper civil securities fraud action, primarily because the alleged tipper was a broker or corporate officer, even though (i) the rights of action involved are not expressly granted by the statutes at issue but are implied by the courts and (ii) the plaintiffs-tippees violated the very same statutes with a degree of culpability at least equal to that of the alleged tippers.

The parties to the proceedings below are:

Petitioner here and Defendant/Appellee below, BATEMAN EICHLER, HILL RICHARDS, INCORPORATED, a corporation;[1]

Respondents here and Plaintiffs/Appellants below, CARL F. BERNER, an individual, CHARLES BRUNER, an individual, DENNIS T. DEMETRE, an individual, LAWRENCE EPSTEIN, an individual, BARRY S. GLASS, an individual, HERBERT GREENBAUM, an individual, ROBERT M. JACOBS, an individual, ARNOLD R. KEILES, an individual, HARRY MITTLEMAN, an individual, and GARRY L. NOBEL, an individual; and

Respondents here and Defendants/Appellees below, CHARLES P. LAZZARO, an individual, LESLIE L.

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[1]Petitioner Bateman Eichler, Hill Richards, Incorporated has the following parent company: Batehill, Inc., which in turn is a wholly-owned subsidiary of Kemper Corporation.

Except as aforesaid, petitioner has no parent company, subsidiary, or affiliate within the meaning of Supreme Court Rule 28.1.

NEADEAU, an individual, and T.O.N.M. OIL & GAS EXPLORATION CORPORATION, a corporation.

In addition, the SECURITIES AND EXCHANGE COMMISSION appeared as Amicus Curiae before the Ninth Circuit Court of Appeals.

OPINIONS BELOW

The Opinion of the Court of Appeals rendered April 13, 1983 and amended July 26, 1984 is reported at 730 F.2d 1319 (9th Cir. 1984). The original Opinion is Appendix A to this Petition ("App. A-1"). The Order of the Court of Appeals amending the Opinion and denying rehearing and rehearing en banc was entered July 26, 1984 and is Appendix B to this Petition ("App.B-1"). The unreported Order of the United States District Court for the Central District of California was entered April 18, 1983 and is Appendix C to this Petition ("App.C-1").

JURISDICTION

The judgment of the Court of Appeals was entered on April 13, 1984. A Petition for Rehearing with a Suggestion for Rehearing En Banc was timely filed on April 30, 1984. The Petition for Rehearing was denied and the opinion was modified by an updated order entered July 26, 1984. This Petition for Writ of Certiorari is being timely filed within 90 days thereafter. (28 U.S.C. § 2101(c); Supreme Court Rule 20.2, 20.4). The jurisdiction of the Supreme Court is invoked pursuant to 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

This case involves the usual securities anti-fraud statutes and rule, Sections 17(a) of the Securities Act of 1933 (the "Securities Act"), 15 U.S.C. § 77q; Section 10(b) of the Securities Act of 1934 (the "Securities Exchange Act"),

15 U.S.C. § 78j; and Securities Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5, each of which is printed in full in Appendix D ("App. D-1").

The issue presented in the Petition also is affected by Section 16 of the Securities Act, 15 U.S.C. § 77p; Section 28(a) of the Securities Exchange Act, 15 U.S.C. § 78bb; and the enforcement provisions of the recently enacted Insider Trading Sanctions Act of 1984.

Section 16 of the Securities Act, 15 U.S.C. § 77p, states:

> The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity.

Section 28(a) of the Securities Exchange Act, 15 U.S.C. § 78bb, contains the same provision.

The enforcement provisions of the Insider Trading Sanctions Act, § 2, 1984 U.S. Code Cong. & Ad. News (98 Stat.) 1264, to be codified at Section 21(d)(2) of the Securities Exchange Act, 15 U.S.C. § 78u(d)(2), state in full:

> (A) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information in a transaction (i) on or through the facilities of a national securities exchange or from or through a broker or dealer, and (ii) which is not part of a public offering by an issuer of securities other than standardized options, *the Commission may bring an action in a United States district court to seek*, and the court shall have jurisdiction to impose, *a civil penalty* to be paid by such person, or any person aiding and abetting the violation of such person. The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not

exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States. If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission shall refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court. The actions authorized by this paragraph may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring. For purposes of section 27 of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this title. The Commission, by rule or regulation, may exempt from the provisions of this paragraph any class of persons or transactions.

(B) No person shall be subject to a sanction under subparagraph (A) of this paragraph solely because that person aided and abetted a transaction covered by such subparagraph in a manner other than by communicating material nonpublic information. Section 20(a) of this title shall not apply to an action brought under this paragraph. No person shall be liable under this paragraph solely by reason of employing another person who is liable under this paragraph.

(C) For purposes of this paragraph "profit gained" or "loss avoided" is the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information. (Emphasis added).

STATEMENT OF THE CASE

In this case, admitted tippee-stock purchasers, armed with what they belived to be material inside information,

defrauded the sellers of the stock in a multitude of open market transactions and now are trying to recover their anticipated but unrealized profits and to recoup their losses from their alleged tippers on the premise that the "tips" were spurious.[2] The decision of the Court of Appeals for the Ninth Circuit enables these plaintiffs to utilize the process of the federal courts to preserve the fruits of their own fraud, free of the *in pari delicto* defense.[3]

The Complaint presents claims for violation of federal and state securities laws as well as for state statutory and common law fraud. The only claims at issue in this Petition are those under Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b); Rule 10b-5, 17 C.F.R. 240.10b-5; and Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a).[4] Jurisdiction of the District Court was invoked under Section 22 of the Securities Act, 15 U.S.C. § 77v, and Section 27 of the Securities Exchange Act, 15 U.S.C. § 78aa.

The District Court granted the motion of defendants BEHR and Lazzaro to dismiss the Complaint under Federal Rule of Civil Procedure 12(b)(6) and dismissed it as to all

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[2]Although the decision of the District Court was based upon a motion to dismiss, the facts underlying the *in pari delicto* defense are fully developed. Perhaps to present the issue squarely, plaintiffs pled in extensive detail facts demonstrating their knowing receipt of putative confidential inside information and use of such information to purchase stock at an assumed bargain price, thereby defrauding their sellers.

[3]The decision of the Court of Appeals is not dependent upon further factual development at trial. Rather, its clear-cut holding is that an alleged tipper-broker defendant may not assert or prevail upon the *in pari delicto* defense against the plaintiff customer-tippee.

[4]The Ninth Circuit affirmed the District Court's dismissal of an additional purported federal securities law claim under Section 15 of the Securities Exchange Act, 15 U.S.C. § 78o, which is not in issue here.

defendants. The court therefore necessarily accepted as true the material, well-pleaded allegations of plaintiffs' complaint. Plaintiffs appealed the dismissal to the Ninth Circuit Court of Appeals, and the Securities and Exchange Commission filed a brief as amicus curiae and presented oral argument there.

The Complaint sets forth all the facts necessary for application of the *in pari delicto* defense. It alleges that plaintiffs purchased T.O.N.M. Oil & Gas Exploration Corporation stock expressly "on the premise" that information plaintiffs had received from Lazzaro, a BEHR broker, was "not information available to the general public." (App.A-2; 730 F.2d at 1320). According to the Complaint, Lazzaro induced plaintiffs to purchase T.O.N.M. stock by telling them that T.O.N.M. had acquired rights to a large gold deposit discovered in Surinam, that it was about to enter into a joint venture agreement with a large mining company to mine the gold, that it would issue to its shareholders stock in its subsidiary without additional consideration, and that for these reasons the value of T.O.N.M. stock would increase dramatically from $1.50 per share to between $10 and $15 per share when T.O.N.M. publicly released the information. *Id.*[5]

Plaintiffs did not passively rely on this information. Instead, they undertook to confirm it before commencing a massive purchasing plan which required, for its success, that plaintiffs withhold these "tips" from the other parties to their trades. Plaintiffs thus contacted T.O.N.M. president Leslie Neadeau to verify the accuracy of their "tips," but Neadeau would neither confirm nor deny them. Significantly, plaintiffs did learn from Neadeau, however, that

[5]Defendants Lazzaro and BEHR deny unequivocally the truth of plaintiff's charges. However, of course, on motion to dismiss the allegations are assumed to be true, *arguendo*.

such information was "not public knowledge" and that Lazzaro was very "trustworthy and a good man." *Id.*

With confidence that they possessed inside information and could obtain stock from innocent sellers at a fraction of its true value, plaintiffs then purchased T.O.N.M. stock in the public markets from November 1979 through much of 1980 without disclosing the information to the sellers. (App. A-2-3; 730 F.2d at 1320). Meanwhile, the price of T.O.N.M. stock did rise to $7 per share in late 1980. Then, with public news that the mining venture would not go forward, the stock fell sharply to less than $1 per share in the second quarter of 1981.

Plaintiffs, unwilling to bear the losses their illegal conduct occasioned, sought by this suit to recover their losses and their anticipated profits from their alleged tippers on the basis that some of the non-public information was false or incomplete. The District Court dismissed the suit on the basis of decisions from the Third and Fifth Circuit Courts of Appeals, denying to such plaintiffs a judicial remedy to obtain the benefits of their own violation of the federal securities laws. (App. A-3; 730 F.2d at 1320).

In a stunning departure from the settled rule that has been adopted by every other circuit court previously confronted with the issue, the Ninth Circuit Court of Appeals reversed and held that these tippees, who traded on material inside information with an intent to defraud innocent investors, are immune from the bar of the *in pari delicto* defense in a lawsuit against their brokers and corporate insiders. The Court below explicitly recognized that it has "reached a result in this matter which is contrary to the views expressed in *Tarasi v. Pittsburg National Bank*, 555 F.2d 1152 (3d Cir.), *cert. denied* 434 U.S. 965 (1971), and *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969)." (App. A-10; 730 F.2d at 1324). The Court did not

mention the decisions of the Eleventh and Fourth Circuits, which upheld the availability of the *in pari delicto* defense in *Silverberg v. Paine, Webber, Jackson & Curtis, Inc.*, 710 F.2d 678 (11th Cir. 1983), concluding that the *in pari delicto* defense was applicable in securities cases although the facts of the particular case before the court there did not warrant applying the defense, and in *Malamphy v. Real-Tex Enterprises, Inc.*, 527 F.2d 978 (4th Cir. 1975), approving application of the *in pari delicto* defense against an investor asserting common law claims.

Even though the Court of Appeals below acknowledged that the plaintiffs-tippees in the present case and in the *Tarasi* and *Kuehnert* cases also "violated the federal securities laws," the Court, without any analysis of plaintiff's conduct here, rejected what it characterized as those courts' conclusion that "a duped investor is equally at fault in the fraud perpetrated against him by his broker or an insider." (App. A-10; 730 F.2d at 1324).

The Court of Appeals' decision is additionally grounded on the fallacious premise that in the securities law context, "[p]ublic policy encourages private actions as enforcement devices for the public interest, even though a windfall may accrue to a wrongdoing plaintiff" (App. A-4-5; 730 F.2d at 1321). The Court of Appeals reached this conclusion by improper reliance on *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), where this Court restricted the circumstances under which the *in pari delicto* defense might be applied to bar private civil *antitrust* actions. Without any analysis of the crucial differences between the enforcement provisions of the federal antitrust laws and the securities laws, including the absence in the securities laws of an express private right of action under Section 17 of the Securities Act or Section 10(b) of the Securities Exchange Act, much less a private right of action for treble civil damages, both

found in the antitrust laws, the Court of Appeals assumed that encouragement of private actions such as this was necessary to serve the market-protecting goals of the Securities Act and the Securities Exchange Act. (App. A-7-8; 730 F.2d at 1322-23). The Court meanwhile disregarded the harm that its conclusion would impose on the securities markets by removing an inhibition to insider trading.

I

THE COURT OF APPEALS' DECISION HAS ERRONEOUSLY SWEPT AWAY THE COMMON LAW DEFENSE OF *IN PARI DELICTO* BASED ON A PURPORTED "POLICY" WHICH THE CONGRESS DID NOT EXPRESS AND ON A "STATUTORY" REMEDY WHICH CONGRESS DID NOT PROVIDE BUT WHICH THE COURTS IMPLIED.

The Court of Appeals' decision erases the common law doctrine of *in pari delicto* to favor private statutory securities fraud claims that would not exist without the importation of that right of action into the securities antifraud statutes. Having sanctioned a private right to damages under the securities antifraud statutes by implication, the Court below now has gone a step further and "found" in those laws an intent to exclude a centuries- old and still honored common law defense.

Yet even the Ninth Circuit Court of Appeals itself had previously recognized that "silence of Congress cannot be construed as an intention to make [common law and equitable] defenses unavailable." *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 213 (9th Cir. 1962), *quoting Straley v. Universal Uranium and Milling Corp.*, 289 F.2d 370, 373-74 (9th Cir. 1961). In *Royal Air*, the Court held that the defenses of estoppel and waiver were available in actions brought under Section 10(b) of the Securities Exchange

Act. *Royal Air Properties, Inc. v. Smith, supra,* 312 F.2d at 213. The Court of Appeals there stated:

> Since civil liability was judicially implied [under Section 10(b)], the appropriate common law defenses should be applicable. . . . *Since courts generally interpret statutes in the context of the common law and Congress has not specifically denied the availability of these defenses, we see no reason why the ordinary defenses of estoppel and waiver should not be applicable.* The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act.

Id. at 213-14 (Emphasis added).

The decision of the Court of Appeals below also ignores the savings clauses of the Securities and Securities Exchange Acts, which each state that "[t]he rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity." Section 16 of the Securities Act, 15 U.S.C. § 77p; Section 28 of the Securities Exchange Act, 15 U.S.C. § 78bb.

Furthermore, the Court below has eliminated the *in pari delicto* defense by reference to a "policy" of using private actions to promote securities law enforcement purposes, although the Congress never has expressed this need in its efforts to control insider trading and, indeed, elected not to provide for such private actions when it passed the Insider Trading Sanctions Act, just three months ago, vesting enforcement authority over insider trading solely in the SEC. (Insider Trading Sanctions Act, § 2, 1984 U.S. Code Cong. & Ad. News (98 Stat.) 1264 (to be codified at 15 U.S.C. § 78u(d)(2)).

From the earliest days of common law, the courts have refused to aid plaintiffs whose conduct is equally culpable with that of those they seek to sue. *See, e.g., Williams v. Hedley,* 8 East 378, 381-82, 103 Eng. Rep. 388, 389; 1 J. Pomeroy, Equity Jurisprudence §§ 940-42 (5th ed. 1941). The roots of this *in pari delicto* doctrine and its application in the American legal system run deep in the decisional law of the states, and have continuing vitality to this day.[6]

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[6] *See, e.g. Alabama:* J.C. Jacobs Banking Co. v. Campbell, 406 So. 2d 834 (Ala. 1981); *Arizona:* Graham v. Shooke, 107 Ariz. 79, 482 P.2d 446 (1971); *Arkansas:* Long v. Mabry, 250 Ak. 947, 470 S.W. 2d 319 (1971); *California:* Altschul v. Sayble, 83 Cal. App. 3d 153, 147 Cal. Rptr. 716 (1978); *Colorado:* Branham v. Stallings, 21 Colo. 211, 40 P. 396 (1895); *Connecticut:* Tator v. Valden, 124 Conn. 96, 198 A.169 (1938); *Florida:* Whitelock v. Geiger, 368 So. 2d 372 (Fla. App. 1979); *Georgia:* Nash v. Jones, 224 Ga. 372, 162 S.E. 2d 392 (1968); *Hawaii:* Hawaiian Ocean View Estates v. Yates, 58 H. 53, 564 P.2d 436 (Hawaii 1977); *Idaho:* Williams v. Continental Life & Accident Co., 100 Idaho 71, 593 P.2d 708 (1979); *Illinois:* Merchandise National Bank of Chicago v. Kolber, 50 Ill. App. 3d 365, 8 Ill. Dec. 450, 365 N.E. 2d 688 (1977); *Indiana:* Dan Purvis Drugs, Inc. v. Aetna Life Insurance Co., 412 N.E. 2d 129 (Ind. App. 1980); *Iowa:* Johnson v. United Investors Life Ins. Co., 263 N.W. 2d 770 (1978); *Kansas:* Cullen v. Atchison, Topeka & Santa Fe Rwy. Co., 211 Kan. 368, 507 P.2d 353 (1973); *Kentucky:* Ohio River Pipeline Corp. v. Landrum, 580 S.W. 2d 713 (Ky. App. 1979); *Louisiana:* Goldblum v. Boyd, 341 So. 2d 436 (La. App. 1977); *Maryland:* Crockett v. Crothers, 264 Md. 222, 285 A.2d 612 (1972); *Maine:* Mokarzel v. Vorias, 419 A.2d 1017 (Me. 1980); *Massachusetts:* Berman v. Coakley, 243 Mass. 348, 137 N.E. 667 (1923); *Michigan:* Schrier v. B&B Oil Co., 311 Mich. 118, 18 N.W. 2d 392 (1945); *Minnesota:* McCauley v. Michael, 256 N.W. 2d 491 (Minn. 1977); *Mississippi:* Woodson v. Hopkins, 85 Miss. 171, 37 So. 1000 (1905); *Missouri:* Layman v. Uniroyal, Inc., 558 S.W. 2d 220 (Mo. App. 1977); *Montana:* McManus v. Fulton, 85 Mont. 170, 278 P. 126 (1929); *Nebraska:* Loewenstein, v. Midwestern Investment Company, 181 Neb. 547, 149 N.W. 2d 512 (1967); *New Jersey:* Brooks v. Cooper, 50 N.J. E 761, 26 A. 978 (1893); *New Mexico:* Rio Grande Gas. Co. v. Stahmann Farms, Inc., 80 N.M.

This Court and the lower federal courts repeatedly have returned to the common law as a source of sound principles to guide decisions in cases involving federally-granted rights[7]. Thus, this Court has acknowledged a private right of action for damages under Section 10(b) of the Securities Exchange Act because of nearly four decades of decisions implying this remedy (*Herman & MacLean v. Huddleston*,

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432, 457 P.2d 364 (1969); *New York:* Leonard v. Poole, 114 N.Y. 371, 21 N.E. 707 (1889); *North Carolina:* Bledsoe v. Lumber Co., 229 N.C. 128, 48 S.E. 2d 50 (1948); *North Dakota:* Steuber v. Hastings Heating & Sheet Metal Co., 153 N.W. 2d 804 (N.D. 1967); *Ohio:* Cushman v. Flanagan, 186 N.E. 2d 512 (1962); *Oregon:* Merit v. Losey, 154 Or. 89, 240 P.2d 933 (1952); *Pennsylvania:* Feld and Sons, Inc. v. Pechner, Dorfman, Wolfee, Rounick and Cabot, 458 A.2d 545 (Pa. Super. 1983); *Rhode Island:* Gaynor v. Wax, 50 R.I. 194, 146 A. 814 (1929); *South Carolina:* Parr v. Parr, 268 So. C. 58, 231 S.E. 2d 695 (S.C. 1977); *South Dakota:* Degen v. Bayman, 86 S.D. 598, 200 N.W. 2d 134 (1972); *Texas:* General Electric Credit Corp. v. Smail, 584 S.W. 2d 690 (Tex. 1979); *Utah:* Gorringe v. Read, 23 Utah 120, 63 P. 902 (1901); *Virginia:* America-Lafrance v. Arlington County, 169 Va. 1, 192 S.E. 758 (1937); *Washington:* Goldbert v. Sanglier, 96 Wash. 2d 874, P.2d 1347 (1982); *Wisconsin:* General Split Corp. v. P & Atlas Corp., 91 Wis. 2d 119, 280 N.W. 2d 765 (1979).

[7]For example, in *Briscoe v. LaHue*, ____ U.S. ____, 103 S.Ct. 1108 (1983), Mr. Justice Stevens, speaking for the Court, summarized the history of English and American common law in holding that a federal statutory civil rights claim would not lie against a police officer alleged to have given perjured testimony at the claimant's criminal trial because the common law granted parties and witnesses immunity from subsequent damage liability for their judicial testimony. *See Butz v. Economu*, 438 U.S. 478, 501-04 (1978); *Pierson v. Ray*, 386 U.S. 547, 553-54 (1967).

This Court similarly adverts to historical antecedents when it weighs constitutional claims, as when it reconsiders arguments that the Sixth Amendment guarantees the right of the public and the press to attend criminal trials, *Richmond Newspapers, Inc. v. Virginia*, 448 U.S. 555, 574 (1980), or pre-trial suppression hearings, *Gannett Co. v. De Pasquale*, 443 U.S. 368, 384, 386 n.15 (1979).

459 U.S. 375, 380 (1983)), which began with the application of common law principles to a securities law fraud violation in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946). The court held in *Kardon* that the right to recover damages arising from a violation of Section 10(b) and Rule 10b-5 "is so fundamental and so deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very clearly and plainly." *Id.* at 514.

Yet the Court below has lightly elevated this implied private right of action above the correlative right of the common law *in pari delicto* defense to claims by those who themselves act illegally. As demonstrated in Section IV of this Petition, this dispatching of the defense is quite a different matter from this Court's treatment of the defense in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), where this Court was faced with a plaintiff whose conduct was much less culpable than defendant's and with an antitrust statute that, by virtue of its express "private attorney general" provision for private treble damages actions, was deemed to weigh much more heavily against application of the common law defense in many antitrust situations.

II

THE DECISION BELOW CONFLICTS WITH DECISIONS OF OTHER COURTS OF APPEAL BY PERMITTING A DEFRAUDING TIPPEE WHO TRADES ON INSIDE INFORMATION TO AVOID AN *IN PARI DELICTO* DEFENSE WHEN HE SUES A TIPPER FOR SECURITIES FRAUD.

The Courts of Appeals of every other circuit that has dealt with this issue have concluded that when an investor trades on what he believes to be material non-public infor-

mation, the *in pari delicto* defense can and should bar the investor's suit against his purported tipper. *See, e.g., Silverberg v. Paine, Webber, Jackson & Curtis, Inc.*, 710 F.2d 678 (11th Cir. 1983); *Wolfson v. Baker*, 623 F.2d 1074 (5th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981); *Tarasi v. Pittsburgh National Bank*, 555 F.2d 1152 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977); *Malamphy v. Real-Tex Enterprises, Inc.*, 527 F.2d 978 (4th Cir. 1975); *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969).

In addition, four of the five district courts which have considered the question have refused to permit a tippee to avoid the *in pari delicto* defense when he trades on what he believes to be material non-public information and then attempts to sue his tipper. *Compare, e.g., In re Haven Industries, Inc.*, 462 F.Supp. 172 (S.D.N.Y. 1978); *Kirkland v. E.F. Hutton and Co., Inc.*, 564 F.Supp. 427 (E.D. Mich. 1983); *Summerlin v. Blyth Eastman Dillon & Co.*, Fed. Sec. L. Rptr. (CCH) ¶ 99,197 (N.D. Ga. 1983); *and Grumet v. Shearson/American Express, Inc.*, Fed. Sec. L. Rptr. (CCH) ¶ 99,243 (D.N.J. 1983), which have upheld the defense, *with Nathanson v. Weis, Viosin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971), the sole district court which rejected it.

The primary rational of these decisions is that if the *in pari delicto* defense is not allowed, the tippee will have a virtual guarantee as to the veracity of any tip and thus will have every economic incentive to trade, without disclosure, on what he believes to be inside information whenever it comes his way. That is, if the tip is correct, the tippee will reap his profit at the expense of the innocent investing public, and if the tip is false, so long as he is able to sue his alleged tipper, any financial loss will be recovered. Giving a tippee such a no-risk or low-risk investment guarantee can do nothing but increase the amount

of attempted insider trading in the securities markets. Thus, the *in pari delicto* defense must be allowed.

An additional rationale recognized by these cases is that absent some strong contravening public policy, wrongdoers should not be permitted to use, and thus pervert, the judicial system by invoking its processes to recover for their illegal, but unsuccessful, schemes. The following Section demonstrates that no such strong, contravening policy is present here so as to override the common law wisdom underlying the *in pari delicto* defense.

III

THE *IN PARI DELICTO* DEFENSE SHOULD BAR THE CLAIMS OF INVESTOR TIPPEES BECAUSE THEIR CONDUCT IS AT LEAST EQUALLY CULPABLE WITH THAT OF THEIR TIPPERS.

After observing that "[t]he Supreme Court has not considered the applicability of the *in pari delicto* defense as an absolute bar to private actions under the federal securities laws," (App. A-5; 730 F.2d at 1321), the Court of Appeals first reviewed this Court's, and its own, treatment of the defense in *antitrust* actions. Then, despite the recognition in the Third and Fifth Circuits of the inapplicability of antitrust doctrine to a securities violation, misapplied this Court's decision in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), in order to reject the defense.

The Court of Appeals did so without any analysis of the facts behind the two policy underpinnings of the *Perma Life* decision and hence without recognition that the principles behind the denial of an *in pari delicto* defense in *Perma Life* are wholly inapposite to the securities tipper-tippee context. The keystone of Mr. Justice Black's major-

ity opinion was a dual finding, neither element of which is present here: (1) that the plaintiffs there could not be said to be equally responsible for the illegal provisions of the dealership agreement they challenged; and (2) that the Clayton Act's express treble damage "private attorney general" provision evinced Congress' belief that enforcement of national antitrust policy was paramount to otherwise available common law defenses. This Petition addresses the latter issue in Section IV.

The Court of Appeal below noted its agreement with the approach suggested by Mr. Justice White in his concurring opinion in *Perma Life*, 392 U.S. at 146-47, which would deny recovery in a private antitrust action where plaintiff and defendant bear substantially equal responsibility for the injury to one of them. The Court of Appeals here, however, conducted no analysis whatever of the nature and culpability of the conduct of plaintiffs as compared with defendants' alleged conduct and made no determination of the impact of plaintiffs' misconduct on the securities markets.

In rejecting the decisions and reasoning of the other circuits, the Court below also paid no heed to those opinions' central element: By definition a tippee who trades on what he believes to be inside information without disclosing it acts with at least the same degree of scienter as a tipper who disseminates the false inside information. The Court of Appeals' opinion thus holds a securities professional or corporate officer to a higher duty to the market than a tippee-investor, even though it is the tippee whose conduct causes the direct adverse impact on the market.

One of the first decisions to recognize that insider trading will be encouraged if the *in pari delicto* defense is eliminated was *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969), a case quite similar to the present one. There, plaintiff Kuehnert alleged that the president of defendant

Texstar secretly told him that Texstar was about to merge with another company, and that the merger would increase greatly the value of Texstar's stock. Relying on such inside information, Kuehnert thereafter purchased a great deal of Texstar stock on the open market. The tip turned out to be false, the price of the stock fell, and Kuehnert sued the president and Texstar under Rule 10b-5 to recover his losses.

The Fifth Circuit Court of Appeals held that Kuehnert was barred from recovering against his alleged tipper on the ground of *in pari delicto*. The court in *Kuehnert* reasoned that the most effective way to deter tippees from trading on what they believe to be inside information is to remove the tippee's guarantee and to allocate the risk of financial loss upon the tippee-trader in the event of a false tip:

> If a tippee can sue he has, in effect, an enforceable warranty that secret information is true. It is then that he will have free rein. If what he is told is false, he can recover against his informer. If it is true, he will, of course, be liable to his vendors or vendees, but here he may well be protected by the difficulties of discovery. It may be relatively easy to trace insiders; tippees are another matter.
>
> The growth of 10b-5 actions has not thus far been handicapped observably by the absence of suits by tippees against insiders. Nor do we believe that *in pari delicto* and unclean hands have limited the effectiveness of the proxy regulations. Therefore, in view of the substantial deterrent pressures already felt by the corporate insider, *SEC v. Texas Gulf Sulphur Co.*, [401 F.2d 833 (2nd Cir. 1968), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969)], we think it important that tippees, who present the same threat to the

> investing public as do insiders themselves, should be offered appropriate discouragement. We conclude that the better choice is to leave upon persons believing themselves tippees the restraint arising from the fear of irretrievable loss should they act upon a tip which proves to have been untrue. Hence the loss must lie where it falls.

412 F.2d at 705 (footnotes omitted).

This identical concern echoes throughout the decisions of the other courts (except for that of the Ninth Circuit in this case) faced with the question of who should bear the risk of loss in tippee versus tipper civil litigation. For example, in *Tarasi v. Pittsburgh Nat'l Bank*, 555 F.2d 1152 (3rd Cir.), *cert. denied*, 434 U.S. 965 (1977), the Third Circuit Court of Appeals also was faced with a situation much like the present, in which the plaintiff admitted he purchased securities on the premise that the information he received from an "insider" (a loan officer at his bank) was not otherwise available to the general investing public.

When the rumor of an upcoming merger proved to be wrong and the value of plaintiff's securities fell, he brought suit against the bank under Rule 10b-5. In holding that the most effective way to further the policy of deterring future insider trading violations was to deny any admitted wrongdoer-tippee the right to recover his losses from an illegal scheme gone awry, the court recognized that:

> [T]he danger of eliminating *in pari delicto* is that such a stance would give "tippees" almost no incentive to forebear from using inside information. This is so since if the suggested purchase proved unprofitable, the "tippee" might have recourse against his "tipper" on account of the inaccurate leak. The threat of application of *in pari delicto* would eliminate the warranty of the accuracy of the tip that might otherwise exist.

555 F.2d at 1163-64 (footnotes omitted).

See also In re Haven Industries, Inc., 462 F. Supp. 172, 179-80 (S.D.N.Y. 1978), upon which the District Court in the present action relied in upholding the validity of the *in pari delicto* defense ("[E]limination of the *in pari delicto* defense eliminates any incentive for the 'tippee' to refrain from using inside information . . . [because] [i]f what has been disclosed is false, he can recover against the tipper; if the inside information is true, he is virtually certain to make an illegal profit"); *Wolfson v. Baker*, 623 F.2d 1074, 1082 (5th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981) ("[A]ny deterrent effect of threatened liability on the broker may well be more than offset by the inducement to violations inherent in the prospect of a free ride for the customer who . . . is placed in the enviable position of 'heads-I-win tails-you-lose' ").

A. Under the Antifraud Provisions of the Federal Securities Laws, an Investor Owes the Same Duty to the Market as a Securities Professional.

The result below ignores the explicit statutory language of the Securities Act and the Securities Exchange Act which proscribe fraudulent conduct by "any person", ignores the high level of culpability that the trading tippee by definition possesses, and fails entirely to recognize the dynamics of the harm to the market that trading on inside information causes.

The federal securities statutes and rule in issue here govern the rights and duties of *all* investors, not just securities professionals, when they explicitly set one standard for all by proscribing fraudulent conduct by "any person." Securities Act Section 17(a), 15 U.S.C. § 77q(a); Securities Ex-

change Act Section 10(b), 15 U.S.C. § 78j(b); Rule 10b-5, 17 C.F.R. 240.10b-5. These provisions do not limit their application only to conduct by brokers and corporate officers, nor do they impose any hierarchy of guilt or liability.

The only theory that could support the Court of Appeals' finding of inequality as a matter of law is one which posits a higher duty to the market for securities professionals or corporate officers than for tippee-investors. Yet if a hierarchy of culpability were to be created, the tippee who trades on what he believes to be material inside information without disclosing that information to the other party to his transaction would be the more guilty party. The Complaint here is rife with allegations that show that plaintiffs' conduct was grossly culpable under the federal securities laws. Plaintiffs admitted that they believed they had material inside information about a stock and, acting with scienter (here knowing intent, not the mere recklessness which is sufficient to establish liability under the Securities Exchange Act in the Ninth Circuit, *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978)), they fraudulently failed to disclose that information when they traded with innocent investors who only had access to public information about the stock.

The culpability and the mental state of the tippee-plaintiffs and of the alleged tippers therefore were exactly the same, based on the allegations of the Complaint. Thus, the "fault" of the parties under the antifraud statutes is at least equal. Indeed, the fault could even be unequal, with the *tippee* bearing a greater level of scienter than the tipper, who could merely be acting recklessly. Yet in the Ninth Circuit the tippee-trader who dupes the other parties to his transaction may now turn around and sue his broker or corporate insider to recover his losses if the tip proves false and his expected profits do not materialize.

Counsel for Petitioner have not uncovered any basis in the language or history of any other provisions of the federal securities laws applicable to brokers and investors as well which would impose a higher duty on securities professionals. To the contrary, the Second Circuit Court of Appeals recently explicitly rejected the notion that a broker or corporate officer owes a special duty to the market by virtue of his profession. *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 15 (2d Cir. 1983), *cert. denied*, ____ U.S. ____, 104 S.Ct. 1280 (1984), *citing* this Court's opinion in *Dirks v. SEC*, ____ U.S. ____, 103 S.Ct. 3255 (1983).

B. The Investor-Tippee Is the Person Who Directly and Adversely Affects the Market When He Trades Without Disclosing What He Believes to be Inside Information.

The dichotomy drawn in the Court of Appeals' opinion is all the more incongruous because it shields the very persons who are directly causing the damage to the securities markets that the Congress sought to prevent when it enacted the Securities and Securities Exchange Acts. A broker's dissemination of false information about a company does not alter the price of that company's stock or otherwise harm its holders or sellers. But the tippee who trades in the stock, thinking he has an informational advantage over the innocent investor, directly causes an adverse impact on the market. Plaintiffs here thus harmed the market as much as, if not more than, their broker and corporate insiders are alleged to have.

IV

CONGRESSIONAL ACTION, SECURITIES AND EXCHANGE COMMISSION INVOLVEMENT, AND PUBLIC REACTION ALL REVEAL THAT APPLICATION OF THE *IN PARI DELICTO* DEFENSE IN SECURITIES ACTIONS IS AN ISSUE OF NATIONAL IMPORTANCE AND REQUIRES UNIFORM TREATMENT BY THIS COURT.

As soon as the District Court reached its decision here and plaintiffs appealed, the Securities Exchange Commission ("SEC") recognized the national importance of the case and appeared as amicus curiae. The case has now had the impact that the SEC hoped for. The Ninth Circuit Court of Appeals' departure from well-settled law, which in all other circuits bars tippees who act illegally from using the courts to enforce the benefits of their illegal bargains, has already gained national attention, both in the media and within the securities industry. *See, e.g.*, The National Law Journal, May 7, 1984, at 11, col. 1; Los Angeles Times, April 14, 1984, Part IV, at 1, col. 5; The Los Angeles Daily Journal, April 16, 1984, at 1, col 4.

Furthermore, the subject of insider trading itself has been the recent focus of greatly intensified discussion nationwide among securities industry analysts and securities professionals, has become a priority target of the SEC, and most recently has had the attention of the United States Congress, which less than three months ago codified the national will in the Insider Trading Sanctions Act of 1984. This Act provides the SEC, but *not* private litigants, with authority to seek treble damages for losses caused by, or profits won by, any purchaser or seller who trades on material non-public information in violation of the Securities Exchange Act. The Congress clearly felt the subject deserving of uniform national treatment. Equally

clearly, the Congress did not see any compelling national policy requiring assistance from private litigants in enforcing bans on insider trading. The "policy" arguments of the Court of Appeals below thus are factually unfounded, and the Ninth Circuit's reliance on those arguments, which has resulted in an inconsistent standard for liability in this circuit, calls for action by this Court to restore national uniformity.

V

THE NINTH CIRCUIT'S EXTENSION OF THIS COURT'S ANTITRUST DECISION IN *PERMA-LIFE* TO PERMIT SECURITIES FRAUD CLAIMS BY TIPPEES WHOSE CONDUCT IS AT LEAST EQUALLY CULPABLE WITH THAT OF THEIR TIPPERS IS UNWARRANTED UNDER THE EXPLICIT TERMS OF THE *PERMA-LIFE* DECISION AND CONTRARY TO THE RECENTLY ENACTED INSIDER TRADING SANCTIONS ACT.

The Court of Appeals below was willing to set aside the American judicial system's traditional distaste for providing a recovery forum for those whose conduct is unlawful because it apparently believed, without any basis in the record or otherwise, that "[t]he possibility of private action is necessary to deter the insider-tipster from knowingly passing on false information to the investing public." (App. A-9; 730 F.2d at 1323). As noted in the Statement of the Case and in Section III above, the Court of Appeals apparently felt compelled to read its result in light of this Court's decision in the antitrust case of *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968). The Court of Appeals' decision, however, ignores the crucial distinction between the two bodies of law that renders the *Perma Life* decision inapplicable here: Congress, in the antitrust laws, explicitly provided for private actions with

treble damage penalties to foster private enforcement of competition laws. In the securities laws, Congress not only failed to provide an express private right of action for securities fraud in the Insider Trading Sanctions Act of 1984, it provided for enforcement of its treble penalty provisions by the SEC only.

The Court of Appeals' decision also disserves the policies of the securities laws it purports to guard. The Court relegated to a footnote the recognition in the Fifth and Third Circuits of the flaw in its market protection theory and, without any analysis of the market effects of its own decision, disputed those courts' well-reasoned conclusion that permitting recovery by non-disclosing tippees would eliminate a necessary deterrent to unlawful tippee conduct and provide such a tippee with a warranty of no loss.

Under the Ninth Circuit rule, the tippee may now trade with impunity. If the information is intentionally false, he may sue his broker or officer tipper to recover his losses or his expected profits. If the information proves wrong, but his tipper did not act fraudulently, he will likely profit by his trades as the market rises or falls in response to the dissemination of the inside information (as plaintiffs allege it did here (App. A-3; 750 F.2d at 1323)), and the other parties to his trades will suffer, but will in most cases never be able to find him. Finally, if the information proves true, he will reap a bonanza with little fear of detection by the SEC or of location by the other parties to his trades. The Ninth Circuit Court of Appeals' decision has thus fostered the very insider trading that Congress has just attempted to reduce.

CONCLUSION

To re-establish uniformity of decisions, promote the sound public policy articulated in the common law, and restore a fair balance between the rights of plaintiffs and defendants in implied rights of action under the securities antifraud laws, a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the Ninth Circuit.

Respectfully submitted,

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APPENDIX A

Opinion.

United States Court of Appeals for the Ninth Circuit. No. 83-1972, D.C. No. C-82-6717-WWS. Carl F. Berner, Charles Bruner, Dennis T. Demetre, Lawrence Epstein, Barry S. Glass, Herbert Greenbaum, Robert M. Jacobs, Arnold R. Keiles, Harry Mittleman and Gary L. Nobel, Plaintiff-Appellants vs. Charles P. Lazzaro; Bateman Eichler, Hill Richards Incorporated, Leslie L. Neadeau, and T.O.N.M. Oil & Gas Exploration Corporation, Defendants-Appellees.

Filed: April 13, 1984.

Appeal from the United States District Court for the Northern District of California. William W. Schwarzer, District Judge, Presiding. Argued and submitted February 15, 1984.

Before: ANDERSON, SCHROEDER, and ALARCON, Circuit Judges, Alarcon, Circuit Judge:

Appellants seek a reversal of the judgment of the district court granting appellees' motion to dismiss the complaint pursuant to Federal Rule of Civil Procedure 12(b). The trial court determined that the application of the *in pari delicto* doctrine barred appellants from any right to recovery. Because we feel that securities professionals and corporate officers who have allegedly engaged in fraud should not be permitted to invoke the *in pari delicto* doctrine to shield themselves from the consequences of their fraudulent misrepresentation, we reverse and remand for a trial on the merits of appellants' claims.

For purposes of reviewing the lower court's dismissal of appellant's action for failure to state a claim, we must accept the facts alleged in the complaint as true. *California Dump Truck Owners Assn., Inc. v. Associated General Contractors of America*, 562 F.2d 607, 614 (9th Cir. 1977).

PERTINENT FACTS

Appellant's complaint alleges that Charles Lazzaro, a registered representative of the broker dealer firm Bateman Eichler, Hill Richards, Inc., and Leslie Neadeau, president of T.O.N.M. Oil and Gas Exploration Corporation, conspired to manipulate the market price of T.O.N.M. stock by disseminating false information on the pretext that it was inside information.

T.O.N.M. common stock is traded over the counter through the National Association of Securities Dealers System. Appellants purchased T.O.N.M. stock through Lazzaro and other brokers "on the premise" that Lazzaro was privy to "certain information not otherwise available to the general public." Lazzaro allegedly induced appellants to purchase T.O.N.M. stock by representing to them that he knew T.O.N.M.'s president personally and by telling them the following material nonpublic information about T.O.N.M.: it had acquired the rights to a large gold deposit discovered in Surinam; it was about to enter into a joint venture agreement with a large mining company to mine the gold; it would issue to its shareholders stock in its subsidiary without additional consideration; and as a result of these developments the value of T.O.N.M. stock would increase dramatically. He told appellants that the price of T.O.N.M.'s stock would increase from $1.50 per share to between $10 and $15 per share upon publication of the information. Appellants sought confirmation of the foregoing information from Neadeau. He would neither confirm nor deny it. Instead he said that such information was "not public knowledge" and that Lazzaro was very "trustworthy and a good man."

The complaint alleges that these false representations were made with knowledge of their falsity with the intention of creating an artificially high demand and price for such

stock. The representations are alleged to be false or materially incomplete. Appellants purchased T.O.N.M. stock in reliance on the defendants' misrepresentations and as a result of their unlawful scheme.

The price of the stock rose to $7 per share in the latter part of 1980 as a result of the defendants' manipulation. In the second quarter of 1981, the stock fell sharply to less than $1 per share. Thereafter, appellants sold their T.O.N.M. stock at prices substantially below those at which they purchased the stock.

The district court dismissed appellants' damage claim under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder on the ground that appellants were *in pari delicto* with Lazzaro and Neadeau. The court explained that appellants had admitted in their complaint "that they had acted on insider information and therefore were tippees." "If the allegations of the complaint are true," the court stated, "both plaintiffs and defendants violated the particular statutory provision under which recovery is sought." The district court concluded that under such circumstances the *in pari delicto* doctrine automatically barred plaintiffs' claim without balancing relative fault.

DISCUSSION

This court has not previously addressed the question of the application of the defense of *in pari delicto* to a private action by an investor to recover losses caused by the fraudulent misrepresentations of a broker concerning alleged insider information.

We begin our discussion by noting that *in pari delicto* is a common law doctrine of "complex scope, contents, and effects." *Perma Life Mufflers, Inc. v. International Parts Co.*, 392 U.S. 134, 140 (1968). Although it literally means "of equal fault", *id.* at 138, there is a "lack of agreement on a definition of the term '*in pari delicto*', as well as a

disagreement, perhaps, on the standards that should govern the use of the defense to which the term is properly applied." *Id.* at 153 (Harlan, J. concurring and dissenting).

Historically, the doctrine of *in pari delicto* has been used to protect the integrity of the court where it was called upon to decide between two wrongdoers. *See, Limitations on Defenses Under 10(b): In Pari Delicto and Unclean Hands*, 5 U. Richmond L. Rev. 251, 257 (1971). *In pari delicto* has traditionally been applied in the interest of society, rather than that of individual litigants. 3 Pomeroy, *Equity Jurisprudence*, § 940-941 (5th ed. 1941). Thus, where private suits are encouraged to further specific public policies, the question has often arisen concerning whether the doctrine of *in pari delicto* should be limited in order to advance societal interests. Fisher, *Tipsters, Tippees and the Doctrine of In Pari Delicto*, 50 B.U.L. Rev. 87, 93 (1970). Some courts have refused to allow the interposition of the defense when the defendant's misconduct exceeds that of the plaintiff, or when the defense would be detrimental to the public interest. 3 Pomeroy, § 941.

In *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 76 (2nd Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981), the court noted that "[t]he Supreme Court has not displayed much enthusiasm for the *in pari delicto* defense to claims for violation of federal law even when the plaintiff's violation was of the same statute under which he sought relief. *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968)."

In *Perma Life* the majority commented that "[w]e have often indicated the inappropriateness of invoking broad common-law barriers to relief where a private suit serves important public purposes". *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134, 138 (1968). Public policy encourages private actions as enforcement devices

for the public interest, even though a windfall may accrue to a wrongdoing plaintiff. Murray, *Securities Regulation — In Pari Delicto as a Bar to Private Antifraud Action by Tippee Against Tipper*, 43 Mo. L. Rev. 378, 381 (1978).

The Supreme Court has not considered the applicability of the *in pari delicto* defense as an absolute bar to private actions under the federal securities laws. The Court has reviewed the use of this defense in private antitrust actions. In *Perma Life*, 392 U.S. at 138, a majority of the court held that under the facts before it there was no basis for applying the doctrine of *in pari delicto* in an antitrust action. This court confronted the impact of *Perma Life* on antitrust cases in *Javelin Corp. v. Uniroyal, Inc.*, 546 F.2d 276 (9th Cir. 1976), *cert. denied*, 431 U.S. 938 (1977); Accord, *THI Hawaii v. First Commerce Financial Corp.*, 627 F.2d 991 (9th Cir. 1980).

In *Javelin*, we stated that a plaintiff is not barred from recovering because of the equitable defense of *in pari delicto* unless "the illegal conspiracy constituting the antitrust violation would not have been formed but for the plaintiff's participation." *Javelin*, 546 F.2d at 279. In formulating this test, we noted our agreement with the approach suggested by Justice White in *Perma Life*. *Javelin*, 546 F.2d at 279 n.3. There, Justice White stated:

> I would deny recovery where plaintiff and defendant bear substantially equal responsibility for the injury resulting to one of them but permit recovery in favor of the one less responsible where one is more responsible than the other.

Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 146-47 (White, J. concurring).

Thus, in private antitrust actions, it is the law of this circuit that the doctrine of *in pari delicto* does not apply

where the facts show that the plaintiff is less than co-equally responsible for his injury. We see no valid reason for creating a different rule for private actions initiated under the federal securities laws.

In the matter before us, the complaint alleges that the fraudulent scheme was originated by the broker and his coconspirators to manipulate the market price of T.O.N.M. stock for their financial benefit. The complaint further provides that the investors acted in reliance on these representations without knowledge of the true facts. The allegations of the complaint, if proved, would demonstrate that the investors could not have been equally responsible for the injury they suffered as a result of this fraudulent scheme. Therefore, the complaint should not have been dismissed on the basis of *in pari delicto*.

The purpose of the Securities Exchange Act of 1934 is to compel full and fair disclosure in the issuance of securities so that the investors will be adequately protected. *See U.S. v. Carman*, 577 F.2d 556, 564 (9th Cir. 1978) [discussing 1933 Act]. The legislative history of the enactment of the 1934 Act clearly indicates that the "various abuses . . . and the inadequacy of self-regulation by the stock exchanges" precipitated the need for the legislation. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 204 (1975). "[P]revention of frauds against investors was surely a key part of [the purpose behind the securities act], but so was the effort to achieve a high standard of business ethics . . . in every facet of the securities industry". *U.S. v. Naftalin*, 441 U.S. 768, 775 (1978).

The major objective of the federal securities law is undoubtedly to provide protection to the investing public. *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1953). Clearly, at the heart of congressional concern in

enacting the statutes were the abuses committed within the industry, specifically by insiders and brokers.

The Supreme Court has ruled that where the clear legislative purpose of an act or statute would be hindered rather than aided by a judicial sanction prohibiting a right of action by a plaintiff, such sanctions shall not be upheld. In *A.C. Frost & Co. v. Coeur d'Alene Mines Co.*, 312 U.S. 38 (1948), a purchaser of unregistered shares of stock sought to enforce a contract of sale through application of statutory sanctions pursuant to the Securities Exchange Act. The Supreme Court rejected the issuer's defense that the contract be found null and void due to the unlawful misconduct of both parties in negotiating an illegal contract, stating that to deny relief because of the illegality would "seriously hinder rather than aid the real purpose of the statute." *Id.* at 43. Thus, enforcement of the contract was permitted because denial would have encouraged violation of the act and would have defeated its intent.

The rationale of the Supreme Court's decision in *Frost* applies to cases dealing with Section 10 violations brought by investors against defrauding insiders. Section 10 of the act was specifically created to proscribe fraudulent misrepresentations and concealment of material fact by brokers and dealers. Application of the defense in favor of BEHR and Lazzaro and in favor of T.O.N.M. and Neadeau would hinder the purpose and intent of the section. The resources of the Securities Exchange Commission are adequate to prosecute only the most flagrant abuses. *See* A. Bromburg, *Securities Law: Fraud-SEC Rule 10-b-5* §§ 10.1-10.3 (1967). To this end, private actions brought by investors have long been viewed as a necessary supplement to SEC enforcement actions. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975). Even in situations where an investor is not free from blame, private damage actions under these

antifraud and antimanipulation provisions serve not only to compensate injured investors, but also to deter fraud and manipulation by exposing those contemplating unlawful conduct to the threat of private damage liability.[1] "Public confidence in an honest securities marketplace is endangered whenever there are fraudulent activities, even if the accounting of only one investor is involved." Harter, *Rule 10b-5: The In Pari Delicto and Unclean Hands Defenses*, 58 Cal. L. Rev. 1149, 1156 (1970).

Private actions by investors victimized by the fraudulent representations of brokers also protect other investors who were not defrauded from artificial market fluctuations. In the matter before us, appellants allege that the dissemination of false information into the securities market unjustifiably inflated the market value of T.O.N.M. stock. The stock fluctuated from approximately $1.50 a share in 1979 to a high of $7.12 in the fourth quarter of 1980 as a result of the false information. The price crashed down to $1 a share by the end of the second quarter of 1981. This activity may have caused substantial losses for those investors who purchased T.O.N.M. stock in the belief that its price reflected its true market value.

---

[1]We agree with Judge Trask's criticism of the use of the common law defenses in the securities area:

> If a limitation upon common law defenses available to a broker might in some instances allow an unscrupulous investor to recover, this consequence is balanced by the salutary effect which the threat of private suits can have in maintaining adherence to statutory commands. . . . Availability of common law defenses, such as *in pari delicto* . . . serve to make this check upon abuses in the system's internal workings considerably less potent.

Hughes v. Dempsey-Tegler & Co., Inc., 534 F.2d 156, 184 (9th Cir.) (Trask, J. concurring and dissenting), *cert. denied*, 429 U.S. 896 (1976).

Any deterrent effect against the use of insider information through imposition of the *in pari delicto* defense is outweighed by the resulting adverse consequence to the market and innocent investors. The defense eliminates any incentive on the part of the injured investor to bring suit, with the result that many violations of the securities act would remain unexposed. Murray, 43 Mo. L. Rev. at 386. Such a decision would tell the corporate insider that if he releases false information which induces action on the part of a would be tippee, he need not fear private enforcement of the securities law. *Id.* "Without the sanction of civil liability, the insider is likely to go undetected and be left to practice his deceit again, with the incentive provided by the knowledge that he is now virtually immune to civil liability for his violation of rule 10b-5." Harter, 58 Cal. Rev. at 1158.

This result is totally incompatible with the overall aims of the securities law, and of Rule 10b-5. The possibility of private action is necessary to deter the insider-tipster from knowingly passing on false information to the investing public. *See* Note, *Securities Regulation: Doctrines of In Pari Delicto and Unclean Hands Held to Bar 10b-5 Recovery by Tippee Against Corporate Insider*, 1969 Duke L. J. 832, 839. The encouragement of this kind if litigation also serves to publicize fraudulent schemes and enables the victims to discover and seek redress for their loss. Fisher, 50 B.U.L. Rev. at 91. To allow professionals in the securities industry and corporate officers to hide behind the *in pari delicto* defense gives them a license to defraud the investing public with little fear of prosecution. So long as these persons disseminated false information on the pretext that it was "inside" information, they would be shielded from liability in a private civil action. The rule we adopt today will further public policy by providing greater pro-

tection for the investing public. *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50, 52-53 (S.D. N.Y. 1971).

We recognize that we have reached a result in this matter which is contrary to views expressed in *Tarasi v. Pittsburgh National Bank*, 555 F.2d 1152 (3rd Cir.), *cert. denied*, 434 U.S. 965 (1977) and *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969). Both courts upheld orders granting summary judgment on the theory that the investors were *in pari delicto* because they voluntarily committed illegal acts in violation of the federal securities laws.[2] We are not persuaded by the conclusion reached in these circuits that a duped investor is equally at fault in the fraud perpetrated against him by his broker or an insider.

[2]The courts in *Tarasi* and *Kuehnert* were both concerned that permitting a tippee to recover would give him a virtual "warranty of accuracy" on his tips, and thus that he would have no incentive to forbear from using inside information. *Tarasi*, 555 F.2d at 1163; *Kuehnert*, 412 F.2d at 705. *See also In re Haven Industries*, 462 F. Supp. at 179-180. According to this theory, if the tip is correct, the tippee will reap his profit at the expense of the innocent investing public, and, if the tip is false, so long as he is able to sue his alleged tipster his financial loss will be covered.

However, this characterization of the tippee being placed in the position of "heads I win, tails you lose" fails where the investor must allege fraud. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Supreme Court held that to succeed in a private cause of action under Rule 10(b)(5), a plaintiff must prove scienter. Under this rule, a purported tippee does not have a submissible case absent a showing that the tipster possessed an "intent to deceive, manipulate or defraud." *Id.* at 193. "The requirement of scienter erodes any broad 'warranty of accuracy'. The tippee is only warranted against knowing and intentional deceit." Murray, 43 Mo. L. Rev. at 384 n.35.

Far from being guaranteed of success, an investor who trades on inside information has violated Rule 10(b)(5) and subjects himself to potential criminal liability through an action by the SEC. Furthermore, if the tip merely fails to "pan out" or if the information itself proves accurate but the stock fails to move in the anticipated direction, the investor stands to lose all of his investment. Only in the situation where the investor has been deliberately defrauded will he be able to maintain a private suit in an attempt to recoup his money.

CONCLUSION

We have concluded that the defense of *in pari delicto* is inappropriate as the sole basis for the dismissal of a complaint, in a private action under the federal securities laws, unless the alleged facts show that the investor is equally responsible for his injury. Where the pleaded facts show that the investor suffered a loss because he relied upon a broker's fraudulent misrepresentations, a cause of action has been stated which may be answered by denial or barred by pleading and proving an affirmative defense. We reject the notion that a defrauded investor is not entitled to recover damages against a broker or an insider solely because the complaint shows that the plaintiff has violated the federal securities laws. "[A]n investor does not waive or lose the shelter of the Act because he becomes to some extent involved in the illegality of the security sales." *Can-Am Petroleum Company v. Beck*, 331 F.2d 371, 373 (10th Cir. 1964). The judgment is REVERSED.

APPENDIX B

Order.

United States Court of Appeals for the Ninth Circuit No. 83-1972, D.C. No. C-82-6717-WWS. Carl F. Berner, Charles Bruner, Dennis T. Demetre, Lawrence Epstein, Barry S. Glass, Herbert Greenbaum, Robert M. Jacobs, Arnold R. Keiles, Harry Mittleman and Gary L. Nobel, Plaintiff-Appellants. vs. Charles P. Lazzaro; Bateman Eichler, Hill Richards Incorporated, Leslie L. Neadeau, and T.O.N.M. Oil & Gas Exploration Corporation, Defendants-Appellees.

Filed: July 26, 1984.

Before: ANDERSON, SCHROEDER, and ALARCON, Circuit Judges.

The Opinion decided April 13, 1984, has been amended as follows:

A new footnote 1 has been added as follows:

[1]In Footnote 8 of their opening brief, appellants challenge the district court's dismissal of their claim for violation of section 15(c) of the Exchange Act (15 U.S.C. § 780(c). Appellants make no further mention of this contention. The district court correctly dismissed the Section 15(c) claim. No private right of action exists under this section. *Admiralty Fund v. Hugh Johnson & Co.*, 677 F.2d 1301, 1313-14 n.16 (9th Cir. 1982).

By adding this new footnote, the numbering sequence of the footnotes is changed, i.e., the old Footnote 1 becomes Footnote 2, etc.

In the old Footnote 2, on page 1743 of the slip opinion, second column, second line, change the word "through" to "as well as," thus that line will read, "potential criminal liability as well as an action by . . ."

With these changes, the panel has voted unanimously to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed R. App. P. 35(b).

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

APPENDIX C

Order.

United States District Court, Northern District of California, No. C-82-6716-WWS. Carl F. Berner, Charles Bruner, Dennis T. Demetre, Lawrence Epstein, Barry S. Glass, Herbert Greenbaum, Robert M. Jacobs, Arnold R. Keiles, Harry Mittleman and Gary L. Nobel, Plaintiffs, v. Charles P. Lazzaro; Bateman Eichler, Hill Richards Incorporated; Leslie L. Neadeau; and T.O.N.M. Oil & Gas Exploration Corporation, Defendants.

Filed: April 18, 1983.

The plaintiffs in this action allege that Charles Lazzaro, a broker employed by Bateman, Eichler, and Leslie Neadeau, president of TONM Oil and Gas Exploration Corp., conspired to defraud them by making misrepresentations which induced them to purchase TONM stock from November 1979 through much of 1980. Lazzaro is alleged to have represented that:

(a) TONM had found gold in Surinam;

(b) TONM would announce in April 1980 a joint venture with St. Joseph's Mining & Mineral Co. to mine the gold; and

(c) the value of TONM stock would rise dramatically as a result of these developments. Plaintiffs purchased their TONM stock "on the premise" that Lazzaro's information was "not information available to the general public" (Complaint, paragraph 15).

No joint venture was announced in April. According to plaintiffs, Lazzaro told them several times that the announcement had been delayed but was still forthcoming. By the last quarter of 1980, the price of TONM stock had risen to $7.00 per share. At the end of that year, the price fell to $1.00 per share and "some or all" of the plaintiffs

sold their shares. In January 1981 TONM finally announced that there would be no joint venture. In September of that year TONM announced that the SEC had named it in an Order for Private Investigation.

All defendants have moved to dismiss the complaint.

Although the complaint is not pleaded with sufficient particularity, there is no need to rule on this point, for it is clear from the pleadings that plaintiffs are not entitled to relief under any federal statute.

Plaintiffs' first claim is for violation of rule 10b-5. Plaintiffs admit that they acted on insider information (albeit false information) and therefore were tippees. Because trading on insider information is itself a violation of rule 10b-5, courts generally have barred such tippees from maintaining rule 10b-5 actions for alleged fraud in connection with the insider information. *Kuehnert v. Texstar Corporation*, 412 F.2d 700, 702 (5th Cir. 1969); *Tarasi v. Pittsburgh National Bank*, 555 F.2d 1152 (3rd Cir.), *cert. denied*, 434 U.S. 965 (1977).

It is quite true that in applying the general doctrine of pari delicto, courts have engaged in a painstaking balancing of relative fault. *See Woolf v. S. D. Cohn & Company*, 515 F.2d 591 (5th Cir. 1975), *reh'g granted*, 521 F.2d 225 (5th Cir. 1975). This case, however, does not raise those difficulties. Here there is no question that if the allegations of the complaint are true, both plaintiffs and defendants violated the particular statutory provision under which recovery is sought. For the reasons well-stated in Judge Gagliardi's opinion in *In re Haven Industries, Inc.*, 462 F. Supp. 172 (S.D.N.Y. 1978), the Court concludes that plaintiffs are barred from recovering on their rule 10b-5 claims.

Plaintiff's reliance on *Xaphes v. Shearson, Hayden, Stone, Inc.*, 508 F. Supp. 882 (S.D. Fla. 1981) is misplaced inasmuch as plaintiff there was found not to have been a tippee. Nor does plaintiffs' argument that the issue may not be decided on the pleadings have merit; all of the material facts have been alleged in the complaint and are accepted as true for purposes of this motion. *See In re Haven Industries, Inc., supra*, and *Kuehnert* and *Tarasi, supra*, in which the issue was decided on summary judgment.

Plaintiffs' second claim (which merely duplicates their rule 10b-5 claim) is for violation of section 15(c) of the Exchange Act, 15 U.S.C. 78o(c). The Ninth Circuit recently held that there is no private right of action under this section. *Admiralty Fund v. Hugh Johnson & Co.*, 677 F.2d 1301, 1314 n.16 (9th Cir. 1982). Only one reported case is to the contrary, *Franklin National Bank v. L. B. Meadows & Co.*, 318 F. Supp. 1339 (E.D.N.Y. 1970), and it is not persuasive in light of the reasoning of more recent cases such as *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 15-16 (1979). Plaintiffs rely on *Opper v. Hancock Securities Corp.*, 367 F.2d 157 (2d Cir. 1966). In that one-page opinion the court simply stated that a broker who failed to carry out a sale order but disposed of his own stock violated "the Securities Exchange Act" and could be held liable "in a private suit." *Id.* at 158. The trial judge had found a violation of the "antifraud provisions" of the Act, citing both § 10(b) and § 15(c) without relying on either one. The § 15(c) claim must therefore be dismissed.

Plaintiffs' third claim is for violation of § 9(a) of the Exchange Act, 15 U.S.C. § 78i(a) (price manipulation). The period of limitations on a private action under this section is one year after discovery. *Id.* § 78i(e). In this

case it is clear from the face of the complaint that plaintiffs were on inquiry notice more than one year before they filed suit on December 10, 1982. Prices had risen and fallen by the end of 1980 when some of the plaintiffs sold their stock to mitigate their damages. In January of 1981 TONM announced that there would be no joint venture, and in September the SEC began its investigation. No facts are alleged supporting a claim that the statute was tolled. This claim is therefore time-barred.

Plaintiffs' fourth claim is for violation of § 17(a) of the '33 Act. Since that section is practically indistinguishable from § 10(b), *see Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808, 815 (9th Cir. 1981), this claim is barred for the same reason as the rule 10b-5 claim.

Plaintiffs' remaining claims arise under state law. In view of the posture of this case, there are no considerations of judicial economy, convenience and fairness to litigants which would justify a federal court taking jurisdiction of matters of state law. *United Mine Workers v. Gibbs*, 383 U.S. 715, 726 (1966).

Accordingly the complaint is dismissed.

IT IS SO ORDERED.

DATED: April 15, 1983

WILLIAM W. SCHWARZER
United States District Judge

APPENDIX D

Statutory Provisions Involved

Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a), states:

> (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 10(b) of the Securities Act, 15 U.S.C. § 78j(b), states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may

prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5, states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

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CLERK

No. 84-679

In The Supreme Court
Of The
United States

October Term 1984

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED,

Petitioner,

vs.

CARL F. BERNER, et al.,

Respondents.

On Petition For A Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Is the defense of *in pari delicto* inappropriate as the sole basis for dismissal of a complaint in a private action under the federal securites laws, unless the alleged facts show that the investor is equally responsible for his injury?

2. Assuming that a broker or corporate insider has encouraged investors to purchase securities based upon a representation that the investors are being given "non-public" information and such information proves to be untrue and made with the degree of *scienter* for which there would be liablity under this Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), are the duped investors ever *in pari delicto*?

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No. 84-679

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For The Ninth Circuit

BRIEF IN OPPOSITION

OPINIONS BELOW

For purposes of correcting the record, Appendix C referred to in the petition at page 2 is the Order of the United States District Court for the Northern District of California, not the Central District of California.

STATUTES AND REGULATIONS INVOLVED

Respondents dispute petitioner's contention that Section 16 of the Securities Act, 15 U.S.C § 77p, and Section 28(a) of the Securities Exchange Act, 15 U.S.C. § 78bb, affect the issue presented by the petition.

Respondents do not dispute petitioner's contention that Section 2 of the Insider Trading Sanctions Act may affect the issue presented by the petition but respectfully submit that its effect, if any, is to support the conclusion reached by the Ninth Circuit.

STATEMENT OF THE CASE

Petitioner's description of the respondents and their motives as set forth in the petition's statement of the case is colorful, but misleading in terms of the issue, if any, raised by the decision of the Ninth Circuit.

Respondents' complaint alleged that Bateman Eichler, Hill Richards, Incorporated, a broker-dealer, Charles P. Lazzaro, its registered representative, T.O.N.M. Oil & Gas Exploration Corporation, a public corporation, and Leslie L. Neadeau, it's president, engaged in a scheme to manipulate the price of T.O.N.M. stock commencing in November, 1979. (CR:1 at ¶¶ 16, 23). 1/ This

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1/ The CR references are to the Clerk's Record on Appeal, with the number referring to the district court docketing number. CR:1 is the Complaint.

scheme involved representations concerning the business prospects for T.O.N.M. and the relationship between Lazzaro and T.O.N.M. (CR:1 at ¶¶ 15-17, 19-22). The representations are alleged to have been made by the defendants with the intention of inducing purchases of T.O.N.M. stock for the purpose of creating an artificially high demand and price for T.O.N.M. stock. (CR:1 at ¶¶ 16, 29, 31, 34). The representations are alleged to be false (CR:1 at ¶ 30) or materially incomplete (CR:1 at ¶ 33). The defendants are alleged to have known the falsity of the representations. (CR:1 at ¶ 32). The plaintiffs are alleged to have purchased T.O.N.M. stock in reliance on defendants' misrepresentations and as a result of their unlawful scheme. (CR:1 at ¶¶ 15, 41a). Plaintiffs' purchases of T.O.N.M. stock were made through the mechanism of

the National Association of Securities Dealers over-the-counter system ("NASDAQ"), a national securites exchange. (CR:1 at ¶ 14). And, finally the scheme produced a substantial manipulation in the price of T.O.N.M. stock. (CR:1 at ¶ 14).

Thus, what respondents "admitted" in their complaint, what the Ninth Circuit focused upon in rendering its decision, 2/ but what the petitioner resolutely ignores in presenting the issue to this Court, is that respondents were used by petitioner, without their knowledge, in an effort by petitioner to manipulate the securities market.

Petitioner's characterization in its statement of the case of the Ninth Circuit's decision is equally misleading.

2/ See Opinion, App. A-2, A-3.

The Ninth Circuit's conclusion is simply stated:

> "We have concluded that the defense of in pari delicto is inappropriate as the sole basis for the dismissal of a complaint, in a private action under the federal securites laws, unless the alleged facts show that the investor is equally responsible for his injury."

Opinion, App. A-11.

SUMMARY OF ARGUMENT

It is respectfully submitted that the Ninth Circuit's decision is neither "sweeping" nor "stunning". It represents a logical extension of this Court's decisions recognizing a private right of action under the antifraud and market manipulation provisions of the federal securities laws [3] and limiting the use of common law defenses to defeat the

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3/ Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

usefulness of the private action to effectuate the policy underlying federal regulatory schemes. [4]

Any alleged conflict between the decision of the Ninth Circuit below and the decisions of the Third Circuit in Tarasi v. Pittsburg National Bank, 555 F.2d 1152 (3d Cir.), cert. denied, 434 U.S. 965 (1971), of the Fourth Circuit in Malamphy v. Real-Tex Enterprises, Inc., 527 F.2d 978 (4th Cir. 1975), of the Fifth Circuit in Ruehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969), and of the Eleventh Circuit in Silverberg v. Paine, Webber, Jackson & Curtis, Inc., 710 F.2d 678 (11th Cir. 1983), is reconcilable in light of this Court's holding in Ernst & Ernst requiring a plaintiff to

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4/ Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968).

prove scienter in order to prevail under the antifraud provisions of the federal securities laws.

That the private right of action for federal securities law violations was implied by the courts rather than expressly provided by Congress as is the case for federal antitrust law violations is not a basis to distinguish this Court's holding in Perma Life. If anything, the federal courts' uniform determination that effective enforcement for the policy underlying the federal securities laws is so important that a private right of action should be inferred would seem to suggest that any hurdle to such an action must be carefully scrutinized.

Nor does the decision of the Ninth Circuit conflict with any expressed or implied policy of Section 16 and Section 28(a) of the Securities and Securities

Exchange Acts or of the recently adopted Insider Trading Sanctions Act. Sections 16 and 28(a) of their respective acts expand the rights and remedies of the defrauded investor rather than limit them as the application of defenses would do. And, reliance on the lack of private remedies under the Insider Trading Sanctions Act of 1984 (1984 U.S. Code Cong. & Ad. News (98 Stat.) 1264) for enforcing the ban on insider trading fails to address what respondents' complaint puts in issue. Respondents' complaint is not about insider trading. It is about a market manipulation scheme perpetrated by a broker-dealer and corporate insiders in violation of the antifraud provisions of the federal securities laws -- a scheme which used respondents and a scheme by which respondents, undoubtedly other

investors, and the integrity of the securities markets were injured.

Notwithstanding the national importance of the area of law which the decision of the Ninth Circuit addresses, it is respectully submitted that review by this Court on writ of certiorari is not warranted where the decision is entirely consistent with this Court's decisions and where any conflict with decisions of the other circuits can be reconciled.

ARGUMENT AND REASONS FOR DENYING WRIT

A. The Decision of the Ninth Circuit Did Not Sweep Away *In Pari Delicto* As a Defense and Is Not in Substantial Conflict With the Decisions of Other Circuits.

The decision of the Ninth Circuit herein did not "sweep away" the *in pari delicto* defense. Rather, it recognized the defense but held that "equal fault" within the meaning of the defense could

not exist as a matter of law if the respondents proved that they were used unknowingly as part of a scheme to manipulate the market in certain securities as alleged in their complaint.

> "In the matter before us, the complaint alleges that the fraudulent scheme was originated by the broker and his coconspirators to manipulate the market price of T.O.N.M. stock for their financial benefit. The complaint further provides that the investors acted in reliance on these representations without knowledge of the true facts. The allegations of the complaint, if proved, would demonstrate that the investors could not have been equally responsible for the injury they suffered as a result of this fraudulent scheme. Therefore, the complaint should not have been dismissed on the basis of *in pari delicto*."

Opinion, App. A-6.

It is respectfully submitted that this determination is not, as petitioner contends, in substantial conflict with

the determinations made by other circuits.

A key consideration for the Ninth Circuit in reaching its decision was this Court's decision in Ernst & Ernst. It was important for two reasons. First, this Court required a degree of scienter to establish liability in a case under the antifraud provisions of the securities laws and such scienter would be inconsistent with the notion of "equal" fault. 5/ Second, this Court implicitly approved the private action which had previously been recognized by all circuits as in accordance with the broad statutory objective of the federal securities laws. 6/

5/ See Opinion, App. A-10, n. 2.

6/ See Opinion, App. A-6.

Both Kuehnert v. Texstar Corporation, 412 F.2d 700 (5th Cir. 1969), and Malamphy v. Real-Tex Enterprises, Inc., 527 F.2d 978 (4th Cir. 1975), which petitioner contends are in conflict, were decided before Ernst & Ernst. Thus, neither decision could draw the distinction that was drawn in the Ninth Circuit decision.

Moreover, neither the Fourth Circuit nor the Fifth Circuit have concluded that in pari delicto should be a defense in a securities case without a balancing of the relative fault of the parties. 7/

7/ In Malamphy, the Fourth Circuit only concluded that it was not error to submit the defense of in pari delicto to the jury given the facts of the case. The Fifth Circuit's decision in Kuehnert has been clarified in two later cases -- James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974) and Woolf v. S.D. Cohn & Co., 521 F.2d 225 (5th Cir. 1975) -- both of which

[FOOTNOTE CONT'D. ON FOLLOWING PAGE]

Silverberg v. Paine, Webber, Jackson & Curtis, Inc., 710 F.2d 678 (11th Cir. 1983), and Tarasi v. Pittsburg Nat'l Bank, 555 F.2d 1152 (3d Cir. 1977), were both decided after Ernst & Ernst. But, far from being in conflict with the decision of the Ninth Circuit herein, the decision by the Eleventh Circuit in Silverberg would appear to be completely consistent with the Ninth Circuit's conclusion that the defense of in pari delicto is inappropriate "unless the alleged facts show that the investor is equally responsible for his injury". (Opinion, App. A-11.) That is precisely what the Eleventh Circuit decided when it

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[FOOTNOTE CONT'D. FROM PREVIOUS PAGE]

adopt the standard of "clearly mutual, simultaneous and relatively equal" conduct for the defense of in pari delicto to be available.

concluded, as petitioner candidly admitted (Petition at 8), that the facts before the court did not warrant applying the in pari delicto defense. A comparison of the facts presented in Silverberg to the allegations of the respondents' complaint demonstrates that respondents did not act any more culpably than Dr. Silverberg.

The Third Circuit actually recognized that under the Ernst & Ernst decision the absence of an in pari delicto defense would have the greatest impact "on deliberate purveyors of false information", Tarasi, 555 F.2d at 1163, but ultimately adopted a rule which did not draw the distinction between deliberate

and innocent or negligent conduct. 8/ That the Ninth Circuit in its decision was willing to draw the distinction between the two types of conduct does not create the type of irreconcilable conflict between circuits which this Court need consider.

In the final analysis, there is uniformity in the approach of all the circuits to the question of the application of the in pari delicto defense. All of the courts have indicated that it is available. It is the facts of each case

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8/ The Third Circuit adopted an equal fault standard, but concluded that the conduct involved was in the nature of "equal fault" when considered in light of this Court's discussion of "passive" or "coerced" conduct in Perma Life. Tarasi, 555 F.2d at 1162. It is respectfully submitted that the conclusion of the Third Circuit that equal fault existed in Tarasi resulted more from a narrow construction of the holding of Perma Life than an actual belief that the parties were equally at fault.

which determine whether it will be applied.

B. The Ninth Circuit's Decision Is Not an Unwarranted Extension of This Court's Perma Life Holding.

Petitioner contends that the Ninth Circuit's reliance on this Court's Perma Life decision ignores crucial distinctions between the federal antitrust and securities laws and therefore was misplaced. Petition at 15-16 and 23.

The goal of preventing common law barriers to relief in a private suit which serves the important public purpose of a "bulwark" of enforcement is not different simply because the private action is specifically provided for in one regulatory scheme and judicially inferred in another. If anything, the public policy which sustains the inference of a private action for needed enforcement of the regulatory scheme would seem more likely

to compel private action enforcement which is unfettered.

The petitioner also contends that in Perma Life the conduct of the plaintiff was much less culpable than defendants. Petition at 13 and 16.

Respondents respectfully submit that although in Perma Life this Court actually found on the facts that the parties were not of "equal fault" because the plaintiffs had a weaker bargaining position and were coerced into accepting the overall contractual scheme, 392 U.S. at 139, it nevertheless held even in circumstances of equal fault an in pari delicto defense could be considered inappropriate. As Justice Black stated:

> "We have often indicated the inappropriateness of invoking broad common law barriers to relief where a private suit serves important public purposes. . . . A more fastidious regard for the relative moral

> worth of the parties would only result in seriously undermining the usefulness of the private action as a bulwark of anti-trust enforcement."

392 U.S. at 138.

Finally, the petitioner contends that the Ninth Circuit purported to apply the Perma Life policy analysis without any basis in fact. Petition at 8-9 and 23. A review of the decisions relied upon by petitioner reveals that the courts in those cases had no facts upon which to base their conclusion that the proper policy to effectuate would be to deter the taking of the tip. Yet, the SEC, which the petitioner is quick to point out is the only one charged under the Insider Trading Sanctions Act of 1984 with the responsibility for enforcement of the ban on insider trading, filed an amicus brief in the Ninth Circuit advising the court that the proper policy

to effectuate is to deter the giving of tip.

C. The Ninth Circuit Correctly Concluded That the Duped Investor Is Not Equally Culpable.

One issue presented by the petition is, what is the relative fault between a broker or corporate insider who deliberately provides a false tip in order to manipulate a securities market for his own personal gain, versus the investor who has no knowledge that he has been provided deliberately false information under the guise of a tip who attempts, out of the very weakness which the broker or insider intended to exploit, to take advantage of his good fortune in receiving the information which has been imparted to him. The petitioner contends that the investor tippee is at least equally culpable with the scheming broker or corporate insider because the investor

is the very person who directly causes the damage to the securities markets. Petition at 21. That is like saying a bullet is equally culpable with a person who pulls the trigger of a gun. There will be no takers of tips if there are no tips. The opposite is not true. And, if brokers and corporate insiders are protected by the doctrine of in pari delicto even when they disseminate deliberately false tips to manipulate the market, an abundance of such tips will always exist in the hopes that some unsuspecting investors will appear.

D. The Ninth Circuit's Decision Is Not Inconsistent With Either the Policy of the Insider Trading Sanctions Act of 1984 or the Savings Clause of the Securities and Securities Exchange Acts.

The petitioner argues that the absence of private actions under the Insider Trading Sanctions Act of 1984

implies that there is no Congressional policy to encourage duped investors to sue brokers and corporate insiders who provide fraudulent tips. But this argument misses the mark since the duped investors are not suing on an insider trading theory. They are suing under the antifraud provisions of the securities laws because they have been defrauded by an attempt to manipulate the market.

The fact that only the SEC is empowered to bring actions under the Insider Trading Sanctions Act, however, does raise the question of how brokers or corporate insiders, who are deliberately spreading false information under the guise of tips, can be identified so that the SEC may pursue the remedies of the act. In its amicus brief in the Ninth Circuit, the SEC contended that its ability to pursue such conduct in the

securities market would be advanced if duped investors had an incentive to identify the brokers and corporate insiders from whom they were receiving fraudulent tips. Certainly, there is no incentive for a duped investor to identify the source of false information if the doctrine of in pari delicto will prevent him from recovering his losses.

The petitioner also suggests that Sections 16 and 28(a) of the Securities and Securities Exchange Acts imply that the Congressional intent was to preserve the common law defenses, including in pari delicto. Petition at 10. Throughout the petition, the petitioner attempts to make distinctions based upon the absence of express language; e.g., absence of express private action under federal securities laws. Neither of the cited sections "saves" defenses.

CONCLUSION

Despite petitioner's rhetoric and hyperbole the decision of the Ninth Circuit is not a drastic departure from established law. Indeed, it follows and is supported by established law. Moreover, it reflects proper enforcement policy, a fact substantiated by the SEC.

For these reasons, respondents respectfully request that the petition for a writ of certiorari be denied.

Dated: November 29, 1984

Respectfully submitted,

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State of California)
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City and County of San Francisco)

Josie Strupaitis, being first duly sworn upon oath, deposes and says:

That affiant is a citizen of the United States, over 18 years of age, and not a party to the within cause; that affiant's business address is 862 Folsom Street, San Francisco, California 94107; that affiant served three, true and correct copies of the attached **Brief In Opposition to a Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit** on the following person, by placing same in an envelope addressed as follows:

Robert S. Warren, Esq.
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333 South Grand Ave., Suite 4700
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that said envelope was then, on November 29, 1984, sealed and deposited in the United States Mail at San Francisco, California, with the postage thereon fully prepaid; and that there is delivery service

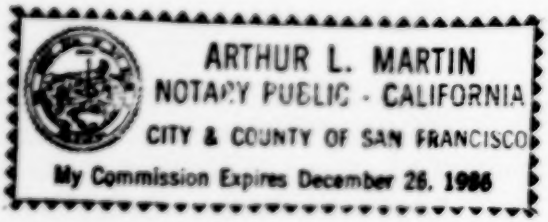
by United States Mail at the place so addressed, or that there is regular communication by mail between the place of mailing and the place so addressed.

Joan Stumpaitis

Subscribed and sworn to
before me this 29th day
of November, 1984

Arthur L. Martin

Notary Public in and for
the City and County of
San Francisco, State of
California



No. 84-679

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED,
Petitioner,

—v.—

CARL F. BERNER, et al.,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF SECURITIES INDUSTRY ASSOCIATION, *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

No. 84-679

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED,

Petitioner,

—v.—

CARL F. BERNER, et al.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF SECURITIES INDUSTRY ASSOCIATION, *AMICUS CURIAE*

Pursuant to Rule 36.2 of this Court, and with the consent of the parties, the Securities Industry Association submits this brief as *amicus curiae* in support of petitioner Bateman Eichler, Hill Richards, Incorporated.

QUESTIONS ADDRESSED

1. Whether the Ninth Circuit erroneously rejected the applicability of the *in pari delicto* defense by holding that a customer who is a willing securities law violator can not be equally at fault with a broker-dealer firm that is alleged also to be a securities law violator, on the grounds that, in the Ninth Circuit's view, Section 10 of the Securities Exchange Act of

1934 was specifically created to proscribe fraudulent conduct by brokers and dealers?

2. Whether the defense of *in pari delicto*, at the very least, should bar vicarious liability on the part of a broker-dealer employer for losses sustained by a customer who intended to profit illegally from false "inside information" provided to him by a registered representative employee?

THE INTEREST OF THE SECURITIES INDUSTRY ASSOCIATION

The Securities Industry Association (the "SIA") is a trade association comprised of approximately 500 securities brokers and dealers transacting business both nationally and internationally. Its membership is responsible for over ninety percent of the securities brokerage business conducted in this country and includes members of every national securities exchange as well as securities firms that are not members of any exchanges.

The SIA's members service securities investors of every size and type and perform a complete spectrum of professional securities activities, including retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, various exchange floor functions, and money management and investment advisory services. As a consequence, the SIA is generally recognized as a spokesman for the securities industry in general and the broker-dealer community in particular.

In reversing the trial court's determination that plaintiffs' securities law claims against Charles P. Lazzaro and Bateman Eichler, Hill Richards, Incorporated were barred by the common law defense of *in pari delicto*, the United States Court of Appeals for the Ninth Circuit raised two issues of substantial concern to the SIA's membership. First, the Ninth Circuit held that the fault of the plaintiff investors, who were knowing and willing securities law violators, could not equal that of the

defendant broker,[1] who allegedly provided them with false information, because, according to the Ninth Circuit, Section 10 of the Securities Exchange Act of 1934 was specifically created to prohibit fraudulent practices by "brokers and dealers." In effect, the Ninth Circuit has rewritten Section 10 to treat securities professionals in one way and all other market participants in another way. This formulation has no basis in law or in sound public policy. The purposes of Section 10, and of the securities laws in general, would not be served by grossly expanding the duties and potential liabilities of securities professionals while diminishing the responsibilities of other market participants who have demonstrated their intention to profit illegally at the expense of the investing public.

Second, without any analysis or discussion at all, the Ninth Circuit's decision denied the *in pari delicto* defense to Bateman Eichler, a broker-dealer employer not alleged to have participated in *any* culpable act.[2] Upon concluding that the fault of the plaintiff securities law violators could not equal that of the registered representative employee and the corporate insider who provided false "inside information" to plaintiffs, the court reversed the dismissal of plaintiffs' complaint as to all defendants.[3] Thus, the only party without fault, the broker-

1 The Ninth Circuit's opinion uses the words "broker," "broker-dealer," and "securities professional" interchangeably, sometimes to refer to Lazzaro, the registered representative, sometimes to refer to Bateman Eichler, the broker-dealer, and sometimes to refer to registered representatives or broker-dealers in general. The Court's failure to recognize a distinction between the registered representative employee and the broker-dealer employer severely impairs its analysis and conclusion. This confusion is noted where necessary throughout this brief.

2 The question of whether the *in pari delicto* defense should be available to one who, at most, is only vicariously liable was not directly presented to the court below. However, the Ninth Circuit held, without considering the issue, that the defense was not available to the broker-dealer employer, Bateman Eichler.

3 Defendants Leslie Neadeau and T.O.N.M. Oil & Gas Exploration Corporation did not join in the motion to dismiss the complaint at the trial court level, nor did they submit a brief on the appeal to the Ninth Circuit.

dealer employer, is exposed to liability for claims by admitted wrong-doers and cannot invoke the *in pari delicto* defense. Analysis of statutory and common law bases of vicarious liability, as well as equitable considerations and sound public policy, suggest that the defense of *in pari delicto* should be available to a broker-dealer employer charged with vicarious liability by admitted securities law violators.

For these reasons, the SIA submits this brief, *amicus curiae*, in support of petitioner Bateman Eichler.

STATEMENT OF THE CASE

In a complaint which admits that plaintiffs intentionally engaged in securities transactions relying upon what they believed to be "inside information," plaintiffs seek to recover from defendants Lazzaro, Bateman Eichler, Leslie L. Neadeau, and T.O.N.M. Oil & Gas Exploration Corporation the losses they sustained when the "inside information" proved to be false. According to the complaint, Lazzaro, a registered representative employed by broker-dealer Bateman Eichler, and Neadeau, president of T.O.N.M., conspired to manipulate the market price of T.O.N.M. stock which they both held. Lazzaro's role in the scheme was to convey false, incomplete, or misleading "inside information" to one or more of the plaintiffs who would then invest in the stock, driving up the market price. Plaintiffs, after implicitly confirming the accuracy of the "inside information" they received from Lazzaro with Neadeau, bought the stock expecting to profit at the expense of other market participants not privy to the "inside information" which plaintiffs believed to be true. Plaintiffs lost an unspecified sum of money and brought this action to recover their losses.

The complaint asserts claims against all defendants for violation of Section 10(b) of the Securities Exchange Act of 1934 (hereinafter referred to as "the 1934 Act"), 15 U.S.C.

§ 78j(b),[4] and Rule 10b-5 of the Securities and Exchange Commission (hereinafter referred to as "Rule 10b-5"), 17 C.F.R. § 240.10b-5, as well as claims under Section 15(c) of the 1934 Act, 15 U.S.C. § 78o(c), Section 9(a) of the 1934 Act, 15 U.S.C. § 78i(a), Section 17(a) of the Securities Act of 1933 (hereinafter referred to as "the 1933 Act"), 15 U.S.C. § 77q(a), and several pendent state law claims. The district court dismissed all of the claims under the federal securities laws and declined to retain jurisdiction over the state law claims. Plaintiffs' claim under Section 15(c) of the 1934 Act was dismissed on the grounds that there is no private right of action under that section.[5] The claim under Section 9(a) of the 1934 Act was dismissed under the applicable statute of limitations.[6] The district court dismissed plaintiffs' claims under Section 10(b) of the 1934 Act and Section 17(a) of the 1933 Act on the grounds that plaintiffs were *in pari delicto* with the defendants.

The Ninth Circuit did not specifically address the claims under Section 17(a) of 1933 Act, but reversed the trial court's ruling on the claims under Section 10(b) of the 1934 Act and Rule 10b-5. The Ninth Circuit based its decision that the defense of *in pari delicto* is not available to defendants in this case primarily on its view that the fault of plaintiffs could not equal that of defendants because Section 10 of the 1934 Act was specifically designed to prohibit fraudulent conduct on the part of "brokers and dealers." The Ninth Circuit reasoned that, in order to further this purpose of the 1934 Act, securities professionals should not be permitted to invoke the *in pari*

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4 Paragraph 41 of the complaint refers to "Section 10(b) of the Securities Act" (defined in paragraph 1 of the Complaint as the Securities Act of 1933) and Rule 10b-5 of the Rules of the Securities and Exchange Commission. We assume plaintiffs intended to claim under Section 10(b) of the 1934 Act.

5 The Ninth Circuit affirmed the trial court's decision on the Section 15(c) claim. *Berner v. Lazzaro*, 730 F.2d 1319, 1320 n.1 (9th Cir. 1984), *cert. granted sub nom. Bateman Eichler, Hill Richards, Inc. v. Berner*, ___ U.S. ___, 105 S. Ct. 776 (1985).

6 Plaintiffs did not challenge that ruling on appeal.

delicto defense in actions by customers who traded upon false "inside information." Thus, the Ninth Circuit reversed the trial court's decision as to all defendants.

The only allegations in the complaint specifically against defendant Bateman Eichler are found in paragraphs 5, 6, and 39. It is alleged that Bateman Eichler was a "controlling person" under Section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a),[7] and that "Lazzaro was acting within the course and scope of his authority and employment and was subject to and under the supervision of . . . Bateman Eichler."[8]

The complaint contains no specific factual allegation[9] that Bateman Eichler knew of, participated in, encouraged, or recklessly failed to discover and prevent the actions of Lazzaro. There is no allegation that Bateman Eichler failed to supervise Lazzaro adequately.

The Ninth Circuit concluded that the *in pari delicto* defense was unavailable to defendants in this case because "a duped investor" could not be equally at fault "in the fraud perpetrated against him by his broker [presumably Lazzaro] or an insider [presumably Neadeau]," but did not consider whether plaintiffs' fault was greater than that of Bateman Eichler, the broker-dealer employer who was not alleged to have engaged in any culpable conduct. Without any discussion of the impact of the *in pari delicto* defense upon a defendant alleged to be vicariously liable, the Ninth Circuit reversed the trial court's dismissal of the complaint as against all defendants.

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7 Paragraphs 5 and 39 of the complaint.

8 Paragraph 6 of the complaint.

9 Paragraphs 3, 28-32, 34-38, and 41, however, contain undifferentiated allegations against all defendants. These general allegations, which are not followed by any specific allegations with respect to Bateman Eichler, are not well-pleaded factual allegations as to Bateman Eichler, and should be disregarded in evaluating Bateman Eichler's motion to dismiss the complaint. *Miree v. DeKalb County*, 433 U.S. 25, 27 n.2 (1977).

SUMMARY OF ARGUMENT

The purpose of the common law defense of *in pari delicto* is to protect the integrity of the courts by declining to arbitrate questions of "honor among thieves" in disputes between equally culpable parties. There is nothing about the facts of the case at bar which should prohibit application of the *in pari delicto* defense in a dispute between equally culpable securities law violators. Here, according to the allegations of the complaint, two willing securities law violators, a registered representative and a corporate insider, devised a scheme which required the participation of other willing securities law violators, an investor or investors. The plaintiffs in the case at bar could not have been injured had they been honest and law-abiding. Instead, plaintiffs incurred losses because they intentionally engaged in concededly unlawful conduct and, therefore, are at least equally responsible for their own losses. There is no basis in the securities laws, in well-reasoned judicial decisions, or in sound public policy for denying the applicability of the *in pari delicto* defense solely because the defendant is a securities professional.

Moreover, there is even less justification for denying the *in pari delicto* defense to a broker-dealer employer who is not alleged to have known about or engaged in any culpable conduct. Whether or not the defense should be available to a registered representative who engaged in unlawful conduct, at the very least the defense should protect a non-culpable employer from claims by an admitted securities law violator seeking damages on theories of "controlling person" liability or *respondeat superior.* A willing securities law violator who concededly is in some measure at fault for his own injury should not be permitted to recover his losses from a broker-dealer on a theory which imposes liability without fault.

ARGUMENT

I. A SECURITIES PROFESSIONAL, BY VIRTUE OF THAT STATUS ALONE, IS NOT INHERENTLY MORE CULPABLE THAN OTHER MARKET PARTICIPANTS FOR VIOLATIONS OF THE ANTI-FRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS.

The Ninth Circuit Court of Appeals and the only district courts which have denied the *in pari delicto* defense in suits by admitted "tippee" securities law violators[10] all recognize the applicability of the defense in private actions under the federal securities laws, but conclude that the fault of a securities professional and a customer in a false "inside information" dispute cannot be equal. While none of these cases devotes any effort to a factual comparison of the fault of the parties, each relies on the notion that the status of securities professional itself renders a defendant in that category more culpable than a plaintiff investor, even though the investor intended to profit from illegal transactions. The view that there can be no equality of fault between two willing wrongdoers simply because one of them is a securities professional finds no support in the securities laws, well-reasoned judicial decisions, or sound public policy.

A. Section 10 of the Securities Exchange Act of 1934 imposes no greater duty on securities professionals than upon other market participants to refrain from fraudulent practices.

The Ninth Circuit begins its analysis by adopting Justice White's guidelines for applying the *in pari delicto* defense as set forth in *Perma Life Mufflers, Inc. v. International Parts*

10 *Meredith v. Bear, Stearns & Co.*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,598 (D.D.C. 1983); *Moholt v. Dean Witter Reynolds, Inc.*, 478 F. Supp. 451 (D.D.C. 1979); *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971).

Corp., 392 U.S. 134, 146-47 (1968); that is, "the doctrine of *in pari delicto* does not apply where the facts show that the plaintiff is less than co-equally responsible for his injury." *Berner v. Lazzaro*, 730 F.2d 1319, 1322 (9th Cir. 1984), *cert. granted sub nom. Bateman Eichler, Hill Richards, Inc. v. Berner*, ____ U.S. ____, 105 S. Ct. 776 (1985). Instead of focusing on the facts of the instant case, however, the Ninth Circuit wanders through a series of erroneous assumptions about the legislative history of the 1934 Act, ultimately reaching the conclusion that the plaintiffs in this case were less than equally responsible for their injury. That conclusion is not justified by the Ninth Circuit's analysis.

First, the Ninth Circuit reviews the purpose of the 1934 Act and comments, without citation, that

> Clearly, at the heart of congressional concern in enacting the statutes were the abuses committed within the industry, *specifically by insiders and brokers*.[11]

Id. (emphasis added). After noting that judicially imposed sanctions should not hinder a clear legislative purpose, the Ninth Circuit again turns to the legislative purpose of the 1934 Act and states, again without any citation to authority, that

> Section 10 of the act was specifically created to proscribe fraudulent misrepresentations and concealment of material fact *by brokers and dealers*.[12]

Id. (emphasis added).

On the strength of its unsupported assumption that Section 10 of the 1934 Act was specifically aimed at "brokers and dealers," the Ninth Circuit decides that permitting defendants Lazzaro and Bateman Eichler to assert the *in pari delicto* defense would hinder the purpose and intent of the section. *Id.*

11 As previously noted, the Ninth Circuit's indiscriminate use of the word "broker" and "brokers and dealers" when it is apparently referring to the registered representative muddies its decision as well as its rationale.

12 *See* footnote 1, *supra*.

Finally, after theorizing that disallowing the defense would encourage exposure of fraudulent conduct by "brokers" and deter the "tipper" from knowingly passing on false information, *id.* at 1323, the Court states:

> We are not persuaded . . . that a duped investor is equally at fault in the fraud perpetrated against him by his broker[13] or an insider.

Id. at 1324.

While the relationship between the Court's assumptions about the purposes of Section 10 and the assumed inequality of fault between the broker and the investor is not clearly stated, it appears that the Ninth Circuit has concluded that, whatever the facts may be, Section 10 applies differently to securities professionals than to other market participants. Such a proposition is unsupportable.

By its express terms, Section 10(b) of the 1934 Act provides:

> It shall be unlawful for *any person*[14], directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (emphasis added).

13 This is a prime example of the confusion and lack of focus in the Court's opinion. Here, the word "broker" can only refer to the registered representative employee, yet the cited premise is a primary basis for the Court's determination to deny the *in pari delicto* defense to all defendants, including the broker-dealer employer.

14 1934 Act § 3(a)(9), 15 U.S.C. § 78c(a)(9), defines the term "person" broadly as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government."

Pursuant to the authority granted above, the Commission promulgated Rule 10b-5, which states:

> It shall be unlawful for *any person*, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (emphasis added).

Similarly, Sections 9(a) and 9(b) of the 1934 Act, 15 U.S.C. § 78i(a) and § 78i(b), which, like Section 10(b), proscribe manipulative devices in securities transactions, make it unlawful for "any person" to do any of the acts specified in such subsections. Clearly, both Section 10(b) and Rule 10b-5 apply across the board to violations committed by *any person*. Their scope is not restricted to those transgressions involving broker-dealers, nor do they single out broker-dealers for special treatment.

The brief materials relating to Section 10(b) in the legislative history of the 1934 Act give no support to the contention of the Ninth Circuit that Section 10 was enacted specifically with a view to regulating conduct by "brokers and dealers." Each of the early versions of Section 10(b) contained the prohibition directed to "any person." Bromberg and Lowenfels, *Securities Fraud & Commodities Fraud* (1983) § 2.2 (310). The section was designed as a "catch-all clause" to give the Commission

power to deal with unforeseen manipulative devices. *Id.* at § 2.2(332). None of the legislative discussions predating its enactment even hint at the possibility that it was specifically directed at securities professionals. *Id.* at § 2.2(340).[15]

In contrast to the above, in those instances where Congress specifically intended that securities professionals as such were to be the subject of regulation, it said so. For example, in Sections 8, 11, 14(b), and 15(a)-(d)[16] of the 1934 Act, the prohibitions are directed against broker-dealers and members of exchanges, and not against "any person." Furthermore, in sections 9(a)(3) and 9(a)(4),[17] the general prohibitions of Section 9(a) are limited to dealers, brokers, and certain other persons. Clearly, when Congress intended to recognize distinctions between securities professionals on the one hand, and the investing public on the other, it did so explicitly, and the language of the anti-manipulative sections of the 1934 Act should not be read otherwise.

The opinion of the Ninth Circuit on the purpose of Section 10 "would add a gloss to the operative language of the statute quite different from its commonly accepted meaning." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199, *reh'g denied*, 425 U.S. 986 (1976). By using the generic term "any person," Congress manifested its intent to impose liability without discrimination on anyone, whether within the securities industry or otherwise,

15 *See, e.g.*, S. Rep. No. 792, 73d Cong., 2d Sess. 18 (1934), *reprinted in* 1 *Federal Securities Laws—Legislative History* (Bureau of National Affairs 1983) 708; H.R. Rep. No. 1838, 73d Cong., 2d Sess. 32-33 (1934), *reprinted in* 1 *Federal Securities Laws—Legislative History* at 1169; Hearings on H.R. 7852 and 8720 before The House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934).

16 1934 Act § 8, 15 U.S.C. § 78h (restricting borrowing and lending by broker-dealers); § 11, 15 U.S.C. § 78k (restricting trading by broker-dealers); § 14, 15 U.S.C. § 78n (regulating broker-dealers' activities with respect to proxy solicitations and tender offers); § 15(a)-(d), 15 U.S.C. § 78o(a)-(d) (requiring registration of broker-dealers and prohibiting broker-dealers from manipulative and deceptive acts in off-exchange transactions).

17 15 U.S.C. § 78i(a)(3) and § 78i(a)(4).

who engages in the practices that the Commission would later proscribe. "Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section." *Id.* at 200. In the case of Section 10, Congress clearly intended that the same anti-fraud standard apply both to securities professionals and to those outside the industry.[18]

Thus, the conclusion that the fault of a customer who willingly violates the securities laws cannot equal that of a securities professional alleged to have violated the same laws may not properly rest upon an assumption that Section 10 of the 1934 Act weighs more heavily on securities professionals than upon other market participants. That false conclusion reached by the Ninth Circuit should be reversed.

B. The mere status of securities professional does not alter the equality of fault between two willing securities law violators.

Although no other court has relied upon the notion that Section 10(b) of the 1934 Act applies more stringently to securities professionals than to other market participants in order to deny the *in pari delicto* defense to a broker-dealer in a claim by a customer, other courts have reached the same result by a different route.[19] In each case, the court struggled to foster the purposes of the federal securities laws by finding a

18 *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 15 (2d Cir. 1983), *cert. denied*, ____ U.S. ____, 104 S. Ct. 1280 (1984) ("We find nothing in the language or legislative history of section 10(b) or rule 10b-5 to suggest that Congress intended to impose a *special duty of disclosure* on broker-dealers simply by virtue of their status as market professionals" (emphasis in original)). *See also Dirks v. SEC*, 463 U.S. 646, n. 26 (1983), where this Court described as "novel" the opinion of Circuit Judge Wright that broker-dealers, by virtue of their status as such, operate under a special duty to the public at large.

19 *Meredith v. Bear, Stearns & Co., supra; Moholt v. Dean Witter Reynolds, Inc., supra; Nathanson v. Weis, Voisin, Cannon, Inc., supra.*

securities professional who willingly violated the law more culpable than a customer who wilfully violated the same law, regardless of the specific facts of the case. While the SIA supports policies designed to foster the purposes of the securities laws, we must point out that denying the applicability of the *in pari delicto* defense to securities professionals simply because they occupy that status will not have the desired result.

As the Ninth Circuit noted, the common law defense of *in pari delicto* was designed to protect the integrity of the courts by sparing them the distasteful task of arbitrating disputes between wrongdoers. 730 F.2d at 1321. If the plaintiff is equally at fault with the defendant, or if the plaintiff's responsibility for his injury is equal to or greater than the defendant's responsibility, the court will leave the parties as it found them. *Creath's Administrator v. Sims*, 46 U.S. 192, 204 (1847).

Most courts that have been asked to allocate losses between a party who knowingly disseminated false "inside information" and a party who intentionally traded on that information hoping to reap illegal profits, have refused to lend the court's assistance to a willing wrongdoer and have left the parties as the court found them—*in pari delicto*.[20]

The Ninth Circuit, however, and the few other courts denying the applicability of *in pari delicto* to false "inside information" cases involving securities professionals, have refused to make factual comparisons of the fault of the parties but,

20 *Wolfson v. Baker*, 623 F.2d 1074 (5th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981); *Tarasi v. Pittsburgh Nat'l Bank*, 555 F.2d 1152 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977); *Malamphy v. Real-Tex Enters., Inc.*, 527 F.2d 978 (4th Cir. 1975); *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969); *Kirkland v. E. F. Hutton & Co.*, 564 F. Supp. 427 (E.D. Mich. 1983); *Summerlin v. Blyth Eastman Dillon & Co.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197 (N.D. Ga. 1983); *Grumet v. Shearson/American Express, Inc.*, 564 F. Supp. 336 (D.N.J. 1983); *In re Haven Indus. Inc.*, 462 F. Supp. 172 (S.D.N.Y. 1978); and *Skinner v. E. F. Hutton & Co.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,909 (N.C. Ct. of Appeals, October 2, 1984).

instead, have found securities professionals more culpable based upon some aspect of that status.[21]

In one of the few district court decisions denying the *in pari delicto* defense to a broker-dealer in a false "inside information" case, the court held:

> *In pari delicto* generally contemplates that both parties are "in equal fault." But this is not the usual situation between the tipper and tippee and their positions are not necessarily equal. Generally, "inside information" is made available by corporate insiders to a select or favored group. The true insider or the broker-dealer is at the fountainhead of the confidential information, whereas the tippee or the customer may be only one of many who innocently or otherwise receives a tip, and whose potential for harm is minimal compared to that of the original source of the information.

Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 57 (S.D.N.Y. 1971) (footnotes omitted).[22] Thus, the court in *Nathanson* concludes that there is no equality of fault because the broker-dealer "tipper" is at the "fountainhead" of the inside information, and that the most effective way to carry out the policy against insider trading is to "nip in the bud the source of the information" by denying the defense of *in pari delicto*. *Id.* at 57-58.

The *Nathanson* rationale has three major fallacies. First, as noted above, the plain language of Section 10 of the 1934 Act prohibits "any person" from engaging in fraudulent practices and makes no distinction between persons at the "fountainhead" and others.

21 The same courts usually impose the same reasoning to find corporate insiders more culpable than other securities law violators as well.

22 In *Nathanson*, the court properly used the term "broker-dealer." There, the broker-dealer itself was alleged to have been an insider and an active participant in the securities laws violations.

Second, in a false "inside information" case, the supposed "tipper" is not at the "fountainhead" of any inside information. The plaintiff in such a case alleges that the information upon which he willingly relied was false. Obviously, false "inside information" is no more available to securities professionals than to anyone else in the marketplace.

Third, denying the *in pari delicto* defense in a false "inside information" case cannot be expected to have any significant impact on the public policy of discouraging insider trading.[23] Real insiders who pass on real inside information to their tippees are not likely to find themselves defendants in suits by tippees.[24] Thus, as a policy matter, the only arguable impact of denying the *in pari delicto* defense in a false "inside information" case would be to embroil the courts in disputes between willing wrongdoers. Avoiding such a distasteful situation is precisely the purpose of the common law *in pari delicto* defense. There is nothing about the status of securities professional which makes a party who intentionally conveys false "inside information" more culpable than a party who intentionally trades on that information expecting to make illegal profits. If two wrongdoers are equally culpable in fact, there is no reasonable justification for denying the defense of *in pari delicto* to the one who happens to be a securities professional.

The fallacious view that, despite equal culpability in fact, a customer can never be *in pari delicto* with a securities professional in a false "inside information" case was carried to its extreme in *Moholt v. Dean Witter Reynolds, Inc.*, 478 F. Supp.

23 Given the onerous consequences tippers face from regulators and criminal law enforcement authorities, fear of relatively rare suits by tippees who suffer losses from trading on false inside information can be expected to have only minimal deterrent impact on "real" tippers.

24 According to the Ninth Circuit, if the tipper believed the information to be accurate, but it proved to be false, a suit by the tippee would be barred by absence of scienter. Thus, denying the *in pari delicto* defense to those who intentionally pass on inside information which, unexpectedly, does not "pan out," would not discourage real tippers because they may not be subject to suit by their tippees in any event. 730 F.2d at 1324 n. 3.

451 (D.D.C. 1979). There, the customers, who were "experienced, sophisticated traders," actually *solicited* inside information from a registered representative. *Id.* at 452. The registered representative complied and "regularly supplied such non-public information on numerous . . . stocks over a period of years." *Id.* at 453. The customers "had for some time been purchasing stocks in reliance on what they were told and perceived to be inside information," and presumably did not complain about the results during that period. *Id.* at 452. Ultimately, the customers made some stock purchases based upon information they believed to be inside information, but which proved false. When they sustained resulting losses, the customers commenced suit alleging that they had been victimized by their registered representative's intentional misrepresentations.

In denying defendants' motion for summary judgment on the defense of *in pari delicto*, the *Moholt* court concluded:

> A licensed broker engaging in conduct such as reflected by this record cannot be said to be equally at fault with his receptive but duped investors, no matter how experienced those investors may be.

Id. at 453. The basis for this rather startling conclusion[25] according to the court is yet another pronouncement on the special status of securities professionals:

> Brokers such as defendants are in the position of quasi-fiduciaries; they are held to a high degree of trustworthiness and fair dealing. In the complex, highly regulated securities field, primary responsibility must rest on licensed brokers and their employees in order to achieve maximum conformance with federal statutes and implementing regulations.[26]

25 The investors, who had been trading for some time on inside information, apparently were not "duped" into trading on inside information until they received a "bad" tip.

26 The *Moholt* court is plagued by the same confusion which afflicts the Ninth Circuit and thus reaches the same confused conclusion. The

Id. at 453. As we have seen, this contention can not be supported by reference to the plain language of the 1934 Act which does not single out any one class of violators but clearly prohibits fraudulent conduct by "*any person*." Thus, for its view that securities professionals are held to some higher duty, the *Moholt* court erroneously relies on *Nathanson*, a case which did not rest its conclusion on the fiduciary responsibility of defendants there.[27] In this context, the "fiduciary" and the "quasi-fiduciary" labels merely state a conclusion reached, but do not aid in the solution of the problem and, in fact, obscure the analysis. The relationship (and responsibility) of registered representative-to-customer in the present case, as in *Nathanson* and *Moholt*, has changed from the norm of agent-to-principal prevalent in most securities transactions and has become a relationship of co-conspirators, or at least aider and abettor-to-primary wrongdoer, in the commission of a fraud on public investors generally. It is preposterous to suggest that one co-conspirator is entitled to a special duty from the other party to a fraud.

The decision in *Moholt* graphically illustrates the danger of ignoring equality of fault under the facts in order to deny the *in pari delicto* defense. Obviously, if the duty placed on the securities professional is heavy enough, it may overcome the most egregious conduct on the part of a plaintiff customer. The consequences are to impose judicially created duties on the securities industry where Congress has declined to do so, and to embroil the courts in disputes involving questions of "honor among thieves." Neither consequence is desirable or warranted.

The federal securities laws set out a complex regulatory scheme which has been supplemented by a lengthy and well-established history of judicial decisions. The radical and unsupportable expansion of duties and potential liabilities for securities professionals resulting from the Ninth Circuit's decision in the case at bar should not be permitted to disrupt that regulatory scheme.

Moreover, the dramatic expansion of duties and potential liabilities for securities professionals which would result from the Ninth Circuit's interpretation of Section 10 of the 1934 Act is clearly not warranted as a means to avoid the effect of the *in pari delicto* defense. Regardless of any duties which may attach to the status of securities professionals, it cannot be denied that *all* market participants have a duty to refrain from fraudulent conduct. A scheme of the sort plaintiffs admit to here *cannot* be perpetrated upon an innocent person. Whether a party intentionally conveying false "inside information" is a securities professional or any other market participant, he cannot accomplish his purpose until he finds another market participant who is willing intentionally to engage in illegal conduct.

This is the classic situation for the *in pari delicto* defense. The courts must not permit honest litigants to be crowded out of court by wrongdoers seeking compensation from wrongdoers.

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word "broker" is used with reference to both registered representative and broker-dealer (in the two quotations above, the work "broker" appears to mean registered representative once, broker-dealer once, and both once), and the *in pari delicto* defense is denied to both without discussion of the broker-dealer's vicarious liability.

27 The *Moholt* court also cited *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1036 (S.D.N.Y. 1977), *aff'd in part*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969); and *Avery v. Merrill Lynch, Pierce, Fenner & Smith*, 328 F. Supp. 677 (D.D.C. 1971). However, none of these cases involved fraudulent activity by a plaintiff.

II. AT THE VERY LEAST, THE *IN PARI DELICTO* DEFENSE SHOULD BAR A CLAIM BY AN INTENTIONAL WRONGDOER AGAINST A BROKER-DEALER EMPLOYER CHARGED ONLY WITH VICARIOUS LIABILITY.

The Ninth Circuit reversed the district court's dismissal of the complaint against all parties because it was not persuaded that what it characterized as a "duped investor" could be equally at fault with "his broker or an insider." 730 F.2d at 1324. As noted above, the word "broker" is undefined, but in the cited passage it presumably means Lazzaro, the registered representative. While the opinion discusses the active wrongdoing of Lazzaro, it does not mention the passive and objectively innocent role of Bateman Eichler. Further, while the Court ultimately denied the *in pari delicto* defense to all defendants, including Bateman Eichler, the Court never considered the applicability of the *in pari delicto* defense to the vicarious liability claim against Bateman Eichler.[28]

The complaint alleges that Lazzaro was employed by Bateman Eichler and that he was acting within the scope and authority of his employment. The complaint also alleges that Bateman Eichler was a "controlling person" within the meaning of Section 20(a) of the 1934 Act and, therefore, is liable to plaintiffs.

There are no other specific factual allegations about Bateman Eichler in the complaint.[29] Significantly, the complaint contains no allegation that Bateman Eichler participated in,

28 While the issue of Bateman Eichler's vicarious liability was not briefed at the Ninth Circuit, the SEC recognized that the issue was present in the facts presented to the court. In the SEC's brief, *amicus curiae*, to the Ninth Circuit at note 3, page 4, the SEC declined to take a position on the question. The fact that the issue was not raised by the parties on the appeal to the Ninth Circuit should not prevent this Court from considering the question. The result of the Ninth Circuit's decision reversing dismissal of the complaint was to decide the issue without considering it.

29 *See* note 9, *supra*.

knew of, should have known of, or recklessly failed to discover Lazzaro's representations to plaintiffs. There is no allegation that Bateman Eichler directly or indirectly encouraged Lazzaro's conduct toward plaintiffs. There is not even an allegation that Bateman Eichler failed to supervise Lazzaro adequately.

Under the analysis utilized by the Ninth Circuit, first the fault of the plaintiff should be measured against the fault of the defendant. Then, the policy impact of permitting or denying the *in pari delicto* defense should be considered in light of the purposes of the securities laws. 730 F.2d at 1322.

Even under the Ninth Circuit's reasoning, however, plaintiffs, as admitted securities law violators, clearly are more culpable than Bateman Eichler, which is not alleged to have engaged in any wrongful conduct. Moreover, even if a special duty is imposed upon Bateman Eichler by virtue of its status as a securities professional, the *in pari delicto* defense should bar plaintiffs' claim because Bateman Eichler is not alleged to have breached any duty. The *in pari delicto* defense or its broader counterpart, the equitable doctrine of "unclean hands," should be available, at the very least, to a non-culpable defendant in a suit by an admitted wrongdoer.

Two principal bases of secondary liability have been utilized to hold broker-dealer employers vicariously liable for their employees' violations of the anti-fraud provisions of the federal securities laws: "controlling person" liability pursuant to Section 20(a) of the 1934 Act[30] and Section 15 of the 1933 Act, 15 U.S.C. § 77o, and the common law agency principle of *respondeat superior*. *Respondeat superior* is an ancient princi-

30 1934 Act § 20(a), 15 U.S.C. § 78t(a), provides: "Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

ple of agency law designed to shift losses inflicted upon *innocent* third parties by agents, acting within the scope of their employment, to employers who, although themselves not culpable, are better able to bear the losses.[31] "Controlling person" liability under Section 20(a) and Section 15 is limited by the "good faith" defense which, in the typical situation, allows a broker-dealer employer to avoid liability by establishing adequate supervision of its employee.

Under either theory of vicarious liability, a defendant employer may be held liable to an innocent plaintiff without a showing of intentional misconduct on the part of the defendant employer.[32] However, the purpose of both theories of vicarious liability is to enable *innocent* investors to recover losses caused by "controlled persons" or agents of the broker-dealer employer. Neither theory of vicarious liability was designed to provide a form of insurance to a culpable plaintiff who participates in causing his own losses by willingly violating the securities laws.

Regardless of whether vicarious liability is claimed under the "controlling persons" provisions of the securities laws or the

31 *See, e.g.*, Prosser, *Law of Torts* (4th ed. 1971) § 69: "The losses caused by the torts of employees, which as a practical matter are sure to occur in the conduct of the employer's enterprise, are placed upon that enterprise itself, as a cost of doing business. They are placed upon the employer because, having engaged in an enterprise which will, on the basis of all past experience, involve harm to others through the torts of employees, and sought to profit by it, it is just that he, rather than the *innocent* injured plaintiff, should bear them . . ." (emphasis added).

32 While the SIA believes that Section 20(a) of the 1934 Act and Section 15 of the 1933 Act are the exclusive bases for vicarious liability under federal securities laws, the Circuit Courts are sharply divided on the issue. This Court has declined to address the question of whether "controlling person" liability excludes or supplements *respondeat superior* liability. *See, e.g., Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *Henricksen v. Henricksen*, 640 F.2d 880 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); *Marbury Management Inc. v. Kohn*, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

common law theory of *respondeat superior*, the fault of a broker-dealer employer alleged to be only vicariously liable cannot possibly equal or exceed the fault of a plaintiff who intentionally violates the securities laws. Moreover, using the terms employed by the Ninth Circuit, plaintiffs in the case at bar cannot possibly be "less than co-equally responsible" for their injury when compared to Bateman Eichler.[33] Thus, the first stage in the analysis employed by the Ninth Circuit, if Bateman Eichler's liability is to be considered at all, leads to the inescapable conclusion that plaintiffs were much more responsible for their own injury than was Bateman Eichler, and plaintiffs' claim should be barred on the strength of the *in pari delicto* or "unclean hands" defense.[34]

This conclusion does not conflict with the policy considerations addressed by the Ninth Circuit in the second stage of its analysis, when it again failed to consider Bateman Eichler's liability. Indeed, the consideration of whether, as a matter of policy, the purposes of the federal securities laws would best be served by denying the *in pari delicto* defense to a non-culpable broker-dealer against a claim by a willing wrongdoer leads to the same conclusion: plaintiffs' claim against Bateman Eichler should be barred. As noted above, permitting the broker-dealer to assert the *in pari delicto* defense against a customer who willingly trades on what he believes to be "inside information" will have no significant impact on tippers who communicate real inside information.[35] However, permitting the defense would discourage "tippees" from trading on tips by denying to "tippees" any guarantee of the accuracy of the "inside information."

33 Viewed from the perspective of causation, plaintiffs' conduct was clearly a proximate cause of their injury, while Bateman Eichler's conduct specifically alleged in the complaint had no significant impact.

34 Indeed, since "*in pari delicto*" means *equally* at fault, perhaps that particular phrase is inappropriate in this case where Bateman Eichler is not alleged to have engaged in any culpable conduct at all.

35 *See* note 24, *supra*.

Moreover, denying the *in pari delicto* defense to a non-culpable broker-dealer employer may not have any salutary effect on supervision of employees by broker-dealers. While an employer can promulgate rules, issue warnings and reminders, and review accounts for inappropriate transactions, a broker-dealer employer cannot monitor every conversation between a registered representative and his customers. The threat of suits by customers who are themselves securities law violators is repugnant, but cannot be expected to have more impact on employee supervision by broker-dealers than that already created by a complex regulatory scheme and the greater likelihood of suits by innocent investors.

Even if this Court should decide that the *in pari delicto* defense is not available to registered representatives who actively participate in illegal activity by communicating false "inside information" to "tippees" who deliberately use that information to the detriment of the investing public, the defense should be available to their broker-dealer employers who are not charged with any wrongful conduct. A customer who knows that an investment he makes on the basis of inside information is not insured by the "deep pocket" of the broker-dealer is less likely to make the illegal investment. Therefore, the policy against fraudulent practices in the securities markets is encouraged by making the *in pari delicto* defense available to broker-dealers sued for vicarious liability by securities law violators, and the policy against embroiling the courts in disputes between wrongdoers is left intact.

CONCLUSION

For the foregoing reasons, this Court should reverse the decision of the Ninth Circuit Court of Appeals and dismiss the complaint against Bateman Eichler, Hill Richards, Incorporated on the grounds that the claim is barred by the common law defense of *in pari delicto*.

Respectfully submitted,

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No. 84-679 (4)

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In the Supreme Court
OF THE
United States

October Term 1984

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED
Petitioner,
vs.
CARL F. BERNER, et al.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

JOINT APPENDIX

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PETITION FOR CERTIORARI FILED OCTOBER 24, 1984
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The following opinion and orders have been omitted in printing this appendix because they appear on the following pages in the appendix to the printed Petition for Certiorari:

Order of District Court, filed April 18, 1983 ..... Pet. App. C-1

Opinion of Court of Appeals, filed April 13, 1984 ..... Pet. App. A-1

Order of Court of Appeals, filed July 26, 1984 ..... Pet. App. B-1

United States District Court
Northern District of California

Date	Proceedings
1982	
Dec. 10	Complaint filed; summons issued.
1983	
Jan. 19	Defendants Neadeau & T.O.N.M. Oil answer complaint.
Jan. 20	Stipulation that defendants Charles P. Lazzaro and Bateman Eichler, Hill Richards ("BEHR") have to and including 2-18-83 within which to respond to the complaint.
Feb. 18	Defendants' (Lazzaro and BEHR) notice of motion and motion to dismiss complaint or, in the alternative, for an order compelling plaintiffs to make a more definite statement; memorandum of points and authorities in support thereof filed.
Feb. 22	Notice: judge to conduct status conference and hearing on defendants' motion to dismiss on 3-25-83 at 11:00 a.m. Previous date of 3-18-83 vacated.
Mar. 11	Order that status conference and hearing set for 3-25-83 be continued to 4-15-83 at 11:00 a.m.
Apr. 8	Defendants (Lazzaro and BEHR) reply memorandum.
Apr. 15	Hearing on plaintiffs' filed motion to file amended complaint and defendants' motion for dismissal and for more definite statement. Motion taken under submission.
Apr. 18	Order that complaint be dismissed. Judgment entered for defendants, each party to bear own costs.
May 13	Notice of appeal by plaintiff. Fee paid. USCA *#83-1972.* Docket fee payment form mailed to USCA and counsel.

United States Court of Appeals for the Ninth Circuit

Date	Filings-Proceedings

1983

May 17 Docket number assigned.

June 3 Filed appellants' civil docketing statement.

July 5 Prebriefing conference order filed: On June 28, 1983 a prebriefing conference was held by telephone before conference attorney Norman P. Vance: (1) Appellants shall file a brief of not more than 30 pages on or before August 26, 1983. (2) Appellees Lazzaro and BEHR shall file a brief of not more than 30 pages on or before October 7, 1983. (3) Appellees Neadeau and T.O.N.M. shall file a brief of not more than 15 pages on or before October 28, 1983. (4) Appellants may file a reply brief of not more than 15 pages within 14 days of the service date of the appellees' brief. (5) If the parties meet this briefing schedule, the appeal should be calendared for argument in December, 1983.

Aug. 19 Filed appellants' motion for an extension of time to file opening brief.

Aug. 24 Filed order (Boochever): Appellants' motion for an extension of time to Sept. 23, 1983 in which to file their opening brief is denied. The opening brief shall be filed no later than Sept. 9, 1983. The briefing schedule is revised as follows: Lazzaro and BEHR shall file their brief on or before Oct. 21, 1983; Neadeau and T.O.M.N. shall file a brief on or before Nov. 10, 1983. In all other respects the conference attorney's order of July 5, 1983 is unchanged. No further requests for extension of time will be granted absent a showing of extraordinary circumstances.

Sept. 12 Filed original and 15 amicus curiae briefs from SEC (17 pgs.).

Date	Filings-Proceedings

Sept. 13 Filed original & 15 appellants' opening briefs (25 pgs.) and 5 excerpts.

Oct. 25 Filed original & 15 appellees' (Lazzaro & BEHR) briefs (29 pgs).

Nov. 28 Filed original & 15 appellants' reply briefs (7 pgs.).

1984

Jan. 31 Filed motion of SEC for leave to participate in oral argument.

Feb. 6 Filed order: The motion of amicus curiae, SEC, to share the appellants' oral argument time is granted. Counsel for the parties are requested to be prepared to discuss the analogy of the in pari delicto defense in antitrust cases. *See, e.g.,* Thi-Hawaii v. First Commerce Financial Corporation,,627 F.2d 991 (9th Cir. 1980).

Feb. 15 Filed additional citation from appellees' attorney.

Feb. 15 Argued and submitted before: Anderson, Schroeder & Alarcon, CJJ.

April 13 Ordered opinion (Alarcon) filed and judgment filed and entered.

April 13 Filed opinion — reversed.

April 13 Filed and entered judgment.

April 30 Filed appellees' petition for rehearing & suggestion for hearing en banc (all judges).

May 4 Received letter from D. Kraus, counsel for appellant dated 5/1/84 re: clarification of the opinion.

July 23 Filed order (Anderson Schroeder & Alarcon, CJJ): The court's opinion in this matter is amended as follows: A new footnote #1 has been added (see

Date Filings-Proceedings

case file). By adding this new footnote, the numbering sequence of the footnotes is changed, i.e., the old footnote #1 becomes footnote #2, etc.

July 26 Filed order (Anderson Schroeder & Alarcon, CJJ): The opinion decided April 13, 1984, has been amended as follows: (see case file). The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

Aug. 3 Mandate issued.

Aug. 3 Filed appellants' notice of change of address.

Nov. 5 Received Supreme Court notice of the filing of certiorari on 10-24-84, SC# 84-679.

1985

Jan. 11 Filed order from Supreme Court granting certiorari.

Jan. 11 Case reopened.

COMPLAINT

IN THE
UNITED STATES DISTRICT COURT FOR
THE NORTHERN DISTRICT OF CALIFORNIA.

CARL F. BERNER, CHARLES BRUNER, DENNIS T. DEMETRE, LAWRENCE EPSTEIN, BARRY S. GLASS, HERBERT GREENBAUM, ROBERT M. JACOBS, ARNOLD R. KEILES, HARRY MITTLEMAN, and GARY L. NOBEL,
Plaintiffs,
vs.
CHARLES P. LAZZARO; BATEMAN EICHLER, HILL RICHARDS INCORPORATED; LESLIE L. NEADEAU; and T.O.N.M. OIL & GAS EXPLORATION CORPORATION;
Defendants.

NO. C 82 6716WWS

COMPLAINT FOR DAMAGES FOR VIOLATIONS OF SECURITIES LAWS; BREACH OF FIDUCIARY DUTY; FRAUD AND DECEIT; CALIF. CORP. CODE §§ 25400 AND 25500 ET SEQ. (Jury Trial Demanded)

Plaintiffs above-named, demanding a trial by jury, complain of the above-named defendants as follows:

I.

JURISDICTION AND VENUE

1. This action is brought under the Securities Act of 1933 (hereinafter called "Securities Act"), the Securities Exchange Act of 1934 (hereinafter called "Exchange Act"), California Civil Code Sections 1572 and 1710, and California Corporations Code Sections 25400 and 25500 *et seq.* Jurisdiction is conferred on this Court by Section 22 of the Securities Act (15 U.S.C. § 77v), Section 27 of the Exchange Act (15 U.S.C. § 78aa), and the pendent jurisdiction of this Court, in order to declare, and to recover damages resulting from, the violations by defendants, as hereinafter alleged, of Section 10[sic](a) of the Securities Act (15 U.S.C. § 77q), of Section 9(a) of the Exchange Act (15 U.S.C. § 78i), of Section 10(b) of the Exchange Act (15 U.S.C. § 78j(b)[)], of Section 15(c) of the Exchange Act (15 U.S.C. § 78o(c)), the rules and regulations issued by the Securities and Exchange Commission pursuant to said sections (particularly Securities and Exchange Commission Rule 10b-5 (17 C.F.R. 240.10b-5)), and the California Civil Code Sections enumerated above.

2. Substantial and significant acts of defendants in connection with the matters hereinafter alleged have occurred in this judicial district. Each of the defendants is found, transacts business or has committed one or more of the unlawful acts, as hereinafter alleged, within the Northern District of California.

3. Each of the defendants directly and indirectly made use of means or instrumentalities of transportation or communication in interstate commerce or of the United States mails in connection with each of the unlawful acts and practices hereinafter alleged.

II.

PARTIES

4. Plaintiff Carl F. Berner is a resident of the County of King, State of Washington. Plaintiffs Charles Bruner, Dennis T. Demetre, Lawrence Epstein, Arnold R. Keiles and Harry Mittelman are residents of the County of Santa Clara, State of California. Plaintiffs Barry S. Glass and Herbert Greenbaum are residents of the City of Baltimore, State of Maryland. Plaintiff Gary L. Nobel is a resident of the County of San Diego, State of California. Plaintiff Robert M. Jacobs is a resident of the County of Contra Costa, State of California.

5. Defendant Bateman Eichler, Hill Richards Incorporated (hereinafter called "Bateman Eichler") is a corporation organized under the laws of the State of Delaware. Bateman Eichler was and is engaged in the business of underwriting and selling securities and was and is transacting business throughout the State of California, including this judicial district. At all times material hereto, defendant Bateman Eichler was a "controlling person" of defendant Charles P. Lazzaro (hereinafter called "Lazzaro") as that term is used in Section 20(a) of the Exchange Act (15 U.S.C. § 78t[(a)]).

6. Defendant Lazzaro was and is a registered representative for the purchase and sale of securities on national securities exchanges and otherwise. On information and belief, he is a resident of the County of San Diego, State of California. At all times relevant hereto, defendant Lazzaro was acting within the course and scope of his authority and employment and was subject to and under the supervision of defendant Bateman Eichler.

7 Defendant T.O.N.M. Oil & Gas Exploration Corporation (hereinafter called "TONM") is a corporation organized under the laws of the State of New Mexico. On

information and belief, TONM issued common stock and approximately 14,400,800 shares were issued and outstanding as of March, 1981.

8. On information and belief, defendant Leslie L. Neadeau (hereinafter called "Neadeau") was and is a resident of the County of Sacramento, State of California. At all times material hereto, Leslie L. Neadeau was and is the president of defendant TONM and owned approximately 100,000 shares of the outstanding common stock of that company. At all times material hereto, TONM was and is engaged in the business of oil, gas and mineral exploration and development, and has its principal place of business in the City of Sacramento, State of California.

9. At all times material hereto, defendants Neadeau and TONM have directly and indirectly participated with, aided and abetted, and conspired with the other defendants in the illegal acts and transactions hereinafter alleged.

III.

FACTUAL ALLEGATIONS

10. In or about 1979, defendant TONM, and its subsidiary, International Gold and Diamond Exploration Corp., Inc., formerly known as the Surinam Gold and Minerals Co., Inc. (a Nevada corporation hereinafter called "IGDE"), entered into joint venture exploration and/or mining agreements with six non-affiliated Surinamese companies pursuant to three-year concession licenses granted to the Surinamese companies by the Minister of Development in Surinam. TONM and IGDE stock was subsequently exchanged with these Surinamese companies in exchange for fractional interests in these concessions. The Surinamese exploration licenses were granted for an initial term of 3 years and could be

extended for an additional 2 years. Also, the exploration licenses can be converted into development licenses, though there is no assurance that the government of Surinam will grant the conversion. All licenses involved rental payments to the Republic of Surinam, and profits made by the companies could be taxed.

11. Plaintiffs are informed and believe and thereon allege that Gold [sic] exploration has been conducted in Surinam (a country formerly known as Dutch Guiana located on the Northeast, Atlantic Coast of South America) for more than a hundred years. However, the highest gold production in Surinam in any one year was 1,209 kilograms in 1908, which figure has steadily declined since that time due to the exhaustion of well-known deposits and the relatively low value of gold against the high costs of exploration and production.

12. Plaintiffs are informed and believe and thereon allege that road access to the concessioned areas to be explored by TONM were limited and the areas were accessible primarily by motorized canoes and helicopter. Those areas were historically mined by Surinamese natives using primitive methods and some gold had been recovered from the area. However, no known ore body of an extent which could be commercialized was defined and, accordingly, TONM's program was an exploratory search for commercial bodies of ore and su sequent [sic] development of same if and when discovered.

13. For the fiscal years ending April 30, 1979-1981, TONM and its subsidiaries showed the following earnings and losses:

Year	Earnings (Losses)
1979	($119,445)
1980	($127,521)
1981	$ 18,481

Furthermore, for the nine months ending October 31, 1981, TONM and IGDE showed losses of $72,740.

14. Plaintiffs are informed and believe and thereon allege that, during the period from May 1, 1979 to June 30, 1981, TONM had approximately 8000 stockholders, and was traded over-the-counter through the National Association of Securities Dealers ("NASDAQ") system. During that period, TONM paid no dividends. Also, during that period, the high and low bid price for TONM stock was as follows:

Quarter/Year	High	Low
3rd/1979	.625	.170
4th/1979	3.250	1.050
1st/1980	6.000	1.150
2nd/1980	3.625	2.130
3rd/1980	5.030	2.750
4th/1980	7.125	3.875
1st/1981	5.010	1.150
2nd/1981	2.000	1.030

15. Commencing in or about November, 1979, defendant Lazzaro directly and indirectly advised plaintiffs to purchase, and plaintiffs did purchase through Lazzaro and other brokers, substantial amounts of TONM over-the-counter stock on the premise that Lazzaro was privy to certain information not otherwise available to the general public. The price of TONM stock when purchased by the plaintiffs herein varied from 1 1/16 to 5 1/4 /share.

16. At various times from November, 1979 through January, 1981, Lazzaro made the following representations, *inter alia*, to some or all of the plaintiffs herein concerning TONM stock, with the intent to induce all of

the plaintiffs herein to purchase substantial quantities of these stocks and to thereby manipulate the price thereon:

a. Vast amounts of gold had been discovered in Surinam, and TONM had options on thousands of acres in gold-producing regions of Surinam.

b. The find had been verified by geological reports and the find compared favorably to, if not better than, those in South Africa.

c. The presence of the find and the geological report(s) were not publically known, but would subsequently be announced.

d. The development of the Surinam gold fields would not require deep mining. Geologists in Surinam were finding gold nuggets in dry creek beds.

e. TONM was negotiating with the St. Joseph Mining & Mineral Company, and possibly other large companies, from as early as February, 1980, to engage in a joint venture to mine the gold in Surinam.

f. The St. Joseph Mining & Mineral Company was to invest two hundred million dollars to mine the gold in Surinam.

g. After that announcement, Lazzaro stated that TONM stock would go up 6-11 points. Thus, TONM stock, which was then selling from $1.50 to $3.00/share, would increase in value to $10 to $15/share within a short period of time, and that [sic] it might increase to $100/share by the end of 1980.

h. TONM shareholders would *automatically* receive 1 share of IGDE for every 5 shares of TONM stock without the payment of any additional monies.

i. Lazzaro and his relatives owned a large block of TONM stock, and neither Lazzaro nor any of his relatives were, at any time, selling their TONM stock.

17. Lazzaro represented that he knew personally the President and/or Vice-President of TONM and TONM was going to announce publicly by April, 1980, that St. Joseph's Mineral & Mining Company was entering into a joint venture with TONM.

18. In or about March, 1980, IGDE issued to stockholders of TONM rights to subscribe to shares of IGDE's common stock at $1.50/share at the rate of 1 right for each 5 shares of TONM common stock held of record. TONM shareholders never, at any time relevent hereto, received rights to subscribe for IGDE shares without payment therefor.

19. In or about April, 1980, certain plaintiffs contacted Leslie L. Neadeau, President of TONM, to attempt to verify Lazzaro's claims concerning the Surinam gold find and whether TONM was going to enter into a joint venture agreement with St. Joseph Mining & Mineral Company or with any other company for the exploration and mining of gold in Surinam. Mr. Neadeau would neither confirm nor deny those claims, stating that they were not public knowledge and that plaintiffs would have to wait for the publication of TONM's annual report. Mr. Neadeau was specifically advised that plaintiffs were dealing with Lazzaro, and Mr. Neadeau told the plaintiffs that he could say that Lazzaro was very trustworthy and a good man.

20. When no announcement of the joint venture was made in April, 1980, Lazzaro stated that the announcement was delayed because of, *inter alia*, certain Securities Exchange Commission filings required because of the

foreign investment, the death of a TONM executive's wife, and because of delays in coordinating the deal between several countries and companies. When the announcement of the joint venture still had not been released by September, 1980, Lazzaro stated the joint venture was still on and that it would be announced shortly. In October or November, 1980, Lazzaro represented that negotiations between TONM and St. Joseph's Mineral & Mining Company had broken down, but that they would resume, and that it was still his recommendation to buy more TONM stock. In January, 1981, TONM announced that the negotiations for a joint venture had terminated and that no new negotiations were contemplated.

21. When the IGDE stock was not issued to plaintiffs by May, 1980 as previously represented by Lazzaro, Lazzaro stated that the issuance of shares had been delayed by a Securities Exchange Commission filing requirement.

22. In or about the fourth quarter of 1980, the price of TONM stock had risen to $7.00/share and some or all of the plaintiffs informed Lazzaro that they wished to liquidate their TONM shares at that time. However, Lazzaro stated that he would let the plaintiffs know when to sell the TONM stock, and that they should not sell just because the stock had reached $7.00/share because it would go higher still.

23. On information and belief, at various times from November, 1979 through October, 1981, Lazzaro controlled over a million shares of TONM stock through stock purchased by himself and his clients. Lazzaro could thereby and did influence and manipulate the price of TONM stock through purchases and sales thereof, and through the dissemination of false information to plaintiffs and others. On information and belief, as a direct

result of Lazzaro's market manipulations and misrepresentations as aforesaid, he caused the price of TONM stock to rise to approximately $7.00/share by the fourth quarter of 1980.

24. By the end of 1980, the price of TONM stock had fallen to approximately $1.00 per share. Thereafter, some or all of the plaintiffs, in order to mitigate their damages, sold their TONM stock at prices substantially below the price at which they had purchased those securities.

25. By the second quarter of 1981, the price of TONM stock had fallen to less than a $1.00 a share.

26. On or about September 14, 1981, TONM announced that it was one of several entities named in an Order for Private Investigation by the Securities and Exchange Commission relating to companies with mining interests in Surinam. The Securities and Exchange Commission was and/or is investigating possible violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act in connection with trading in TONM's shares.

IV.

FIRST CLAIM
(15 U.S.C. § 78j)

27. Plaintiffs incorporate by reference paragraphs 1 through 26.

28. Through the use of means and instrumentalities of interstate commerce, the U.S. mails and facilities of national securities exchanges, defendants, and each of them, separately and in concert, directly and indirectly, aiding and abetting each other, in connection with the purchase and sale of TONM securities for plaintiffs,

knowingly: (a) used and employed manipulative, deceptive and fraudulent devices, schemes and artifices; (b) made untrue statements of material facts and failed to state material facts necessary to avoid the misleading effects of other statements that were made; and (c) engaged in acts, practices and a course of business and business conduct which operated as a fraud and deceit upon plaintiffs. As a result thereof, defendants, and each of them, violated Section 10(b) of the Exchange Act (15 U.S.C. § 78j); Rule 10b-5 of the Rules of the Securities and Exchange Commission (17 C.F.R. 240.10b-5) and other regulations issued by the Securities and Exchange Commission pursuant to Section 10(b).

29. At all times material hereto, defendants, in person and through their employees and agents, communicated to the plaintiffs some or all of the misrepresentations set out in paragraphs 15-22. Those representations were made to induce and communicate certain unlawful representations and schemes and business fraud on the plaintiffs.

30. The representations of the defendants were untrue and/or contained only half-truths, material omissions of fact and falsehoods.

31. The representations were made by the defendants with the intention that the plaintiffs would rely thereon.

32. The defendants knew that the representations as alleged hereinbefore were untrue and/or were made recklessly with wanton disregard for the truth.

33. Many facts which would be relevant to the determination of the true value of TONM stock were withheld from plaintiffs. Specifically, plaintiffs were not told, *inter alia*, that the TONM gold "find" was in the exploration stage, not the development stage; that there was no known body of ore as yet; that there had never been an

agreement reached between TONM and any major company for a joint venture in Surinam; that TONM shareholders would have to pay $1.50/share for IGDE stock; and that TONM lost money in 1980 and made only $18,000 in 1981. All of these facts, among others, were known to defendants and were withheld from plaintiffs.

34. Defendants failed to disclose pertinent facts for [sic] the purpose and intent to deceive plaintiffs and induce them to purchase TONM stock.

35. Defendants had a duty not to prefer or favor their interests over the interests of plaintiffs and were obligated to represent facts and make recommendations in accordance with plaintiffs' best interests for financial security.

36. Instead of protecting plaintiffs' interests, defendants proceeded to generate income to themselves, expenses to plaintiffs, and capital losses to plaintiffs.

37. Plaintiffs relied upon defendants' statements and inducements on the occasions they recommended transactions. These statements and inducements and omissions of facts necessary to make such statements not misleading were material and they resulted in losses to plaintiffs.

38. In buying and selling securities for plaintiffs' accounts, defendants violated and breached their duties and obligations to plaintiff in that:

a. They made numerous material misrepresentations and omissions as hereinbefore alleged.

b. They induced the purchase and sale of TONM securities without any basis or justification other than to profit themselves through the taking of commissions and secret profits.

39. At all times material hereto, Bateman Eichler was a controlling person of Lazzaro, and is therefore liable for

all losses resulting from the violation of federal securities laws herein alleged.

40. At all times material hereto, Neadeau and TONM aided and abetted and conspired in the violation of the federal securities laws herein alleged and are therefore liable for such violations.

41. As a result of defendants' conduct, as hereinabove alleged, in violation of Section 10(b) of the Securities Act, Rule 10b-5 of the Rules of the Securities and Exchange Commission and other regulations issued pursuant to said section and in breach of their fiduciary duties and obligations to plaintiffs, plaintiffs have been damaged in the following respects:

a. Plaintiffs purchased TONM stock at a price substantially higher than the prices at which they were able to sell these securities, thereby suffering capital losses.

b. Plaintiffs did not sell their TONM stock when it reached its highest value, when plaintiffs wanted to sell, thereby suffering lost profits.

c. Plaintiffs did not invest in other, less speculative ventures, thereby suffering lost profits.

Plaintiffs, therefore, have been damaged by defendants in the amount of at least $2,000,000, or such other amount as may be proved at trial.

WHEREFORE, plaintiffs pray for relief as hereinafter set forth.

V.

SECOND CLAIM
(15 U.S.C. § 78o(c))

42. Plaintiffs hereby incorporate by reference paragraphs 1 through 41.

43. Through the use of means and instrumentalities of interstate commerce and the U.S. mails, defendants, and each of them, separately and in concert, directly and indirectly, aiding and abetting each other, induced and effected the purchase and sale of TONM securities for plaintiffs: (a) by means of manipulative, deceptive and fraudulent devices and contrivances; (b) by making untrue statements of material facts and by omitting to state material facts necessary to avoid the misleading effects of other statements that were made, with knowledge and reasonable grounds to believe that the statements and implications therefrom were untrue or misleading; and (c) by engaging in acts, practices and a course of business which operated as a fraud and deceit upon plaintiffs. As a result thereof, defendants, and each of them, have violated Section 15(c) of the Exchange Act (15 U.S.C. § 78o(c) [sic] and the rules and regulations issued by the Securities and Exchange Commission pursuant to said section.

44. As a result of defendants' conduct, as hereinabove alleged, in violation of Section 15(c) of the Exchange Act and the rules and regulations issued by the Securities and Exchange Commission pursuant to this section and in breach of their fiduciary duties and obligations to plaintiffs, plaintiffs have been damaged in each and every respect set forth in paragraph 41 of the First Claim of this Complaint.

WHEREFORE, plaintiffs pray for relief as hereinafter set forth.

VI.

THIRD CLAIM
(15 U.S.C. § 78(i)(a))

45. Plaintiffs incorporate by reference paragraphs 1 through 41.

46. Through the use of means and instrumentalities of interstate commerce and the U.S. mails, defendants, and each of them, separately and in concert, directly and indirectly, aiding and abetting each other, induced and effected the purchase and sale of TONM securities for plaintiffs for the purpose of creating a false or misleading appearance of active trading in TONM securities to raise the value of these securities, and to induce the purchase and sale of these securities: (a) by means of manipulative, deceptive and fraudulent devices and contrivances; (b) by making untrue statements of material facts and by omitting to state material facts necessary to avoid the misleading effects of other statements that were made, with knowledge and reasonable grounds to believe that the statements and implications therefrom were untrue or misleading; and (c) by engaging in acts, practices and a course of business which operated as a fraud and deceit upon plaintiffs. As a result thereof, defendants, and each of them, have violated Section 9(a) of the Exchange Act (15 U.S.C. § 78(i)(a)) and the rules and regulations issued by the Securities and Exchange Commission pursuant to said section.

47. As a result of defendants' conduct, as hereinabove alleged, in violation of Section 9(a) of the Exchange Act and the rules and regulations issued by the Securities and Exchange Commission pursuant to said section and in breach of their fiduciary duties and obligations to plaintiffs, plaintiffs have been damaged in each and every

respect set forth in paragraph 41 of the First Claim of this Complaint.

WHEREFORE, plaintiffs pray for relief as hereinafter set forth.

VII.

FOURTH CLAIM
(15 U.S.C. § 77q)

48. Plaintiffs incorporate by reference paragraphs 1 through 41.

49. Through the use of means and instrumentalities of interstate commerce and the U.S. mails, defendants, and each of them, separately and in concert, directly and indirectly, aiding and abetting each other, in offering and selling TONM securities to plaintiffs: (a) employed and used manipulative, deceptive and fraudulent devices, schemes and artifices; (b) made untrue statements of material facts and omitted to state material facts necessary to avoid the misleading effects of other statements that were made; and (c) engaged in acts, practices and a course of business and business conduct which operated as a fraud and deceit upon plaintiffs. As a result thereof, defendants, and each of them, have violated Section 17(a) of the Securities Act (15 U.S.C. § 77q [(a)]).

50. As a result of defendants' conduct, as hereinabove alleged, in violation of Section 17(a) of the Securities Act and in breach of their fiduciary duties and obligations to plaintiffs, plaintiffs have been damaged in each and every respect set forth in paragraph 41 of the First Claim of this Complaint.

WHEREFORE, plaintiffs pray for relief as hereinafter set forth.

VIII.

FIFTH CLAIM
(Breach of Fiduciary Duty)

51. Plaintiffs incorporate by reference paragraphs 1 through 26, and this Court has pendent jurisdiction over this claim.

52. By reason of the matters alleged hereinabove, defendants Lazzaro and Bateman Eichler assumed the direction, control and management of plaintiffs' financial affairs and they acted in a fiduciary capacity towards plaintiffs and plaintiffs were thereby induced to and did place full trust and confidence in them. Throughout the period that defendants occupied such a position of trust and confidence, plaintiffs were entitled to the highest degree of loyalty from them and were entitled to their faithful services. In addition, they had a duty not to prefer or favor their interests over the interests of plaintiffs and they were obligated to exercise their direction, control and management of plaintiffs' financial affairs in accordance with the circumstances indicated by plaintiffs' expressed wishes and financial condition.

53. By their conduct as hereinabove alleged, defendants Bateman Eichler and Lazzaro violated their fiduciary duties and obligations to plaintiffs and as a result thereof plaintiffs have been damaged in each and every respect set forth in paragraph 41 of the First Claim of this Complaint.

WHEREFORE, plaintiffs pray for relief as hereinafter set forth.

IX.

SIXTH CLAIM
(Fraud and Deceit)

54. Plaintiffs incorporate by reference paragraphs 1 through 26, and this Court has pendent jurisdiction over this claim.

55. Defendants, and each of them, separately and in concert, directly and indirectly, aiding and abetting each other, and acting in a fiduciary capacity in relation to plaintiffs: (a) suggested as fact that which was not true, never believing those suggestions to have been true; (b) asserted as fact that which was not true, never having reasonable ground for believing those assertions to be true; (c) suppressed facts although bound to disclose them and gave information of other facts which did mislead for want of communication of those facts; and (d) made promises without any intention of performing them.

56. Said representations, suggestions, promises, assertions and suppressions of facts were made as to material facts.

57. Defendants were under a duty to correctly state facts, assertions, promises and suggestions of fact and not to suppress other facts in the context of their dealings with plaintiffs.

58. Defendants made these assertions, promises, suggestions of fact and suppressions of fact intending to induce plaintiffs' reliance upon them. Plaintiffs, unaware of the falsity of the representations made, unaware that suggestions of fact were not true, unaware that assertions of fact were not true, unaware of facts suppressed and unaware that the promises made were made without intention to perform them did so rely on defendants' actions and were justified in doing so. As a result thereof

defendants have violated Sections 1572 and 1710 of the California Civil Code.

59. As a result of defendants' conduct, as hereinabove alleged, in violation of California Civil Code Sections 1572 and 1710 and in breach of their fiduciary duties and obligations to plaintiffs, plaintiffs have been damaged in each and every respect set forth in paragraph 41 of the First Claim of this Complaint.

60. In committing all of the foregoing acts of misconduct, defendants acted fraudulently, oppressively, maliciously and in flagrant, aggravated, wanton and reckless abuse of the confidence reposed in them by plaintiffs, and plaintiffs are therefore entitled to and demand damages for sake of example and by way of punishment of defendants in the amount of $5,000,000.

WHEREFORE, plaintiffs pray for relief as hereinafter set forth.

X.

SEVENTH CLAIM
(Negligent Misrepresentation)

61. Plaintiffs incorporate by reference paragraphs 1 through 26, and 54 through 60, and this Court has pendent jurisdiction over this claim.

62. Defendants, and each of them, made these representations with no reasonable ground for believing them to be true in that, on information and belief, defendants did not have accurate information nor any information from inside sources or otherwise concerning, *inter alia,* the Surinam gold "find", the financial status of TONM, and the status of alleged negotiations between TONM and another mining company regarding a joint venture to

explore and/or develop the Surinam gold find, and defendants were aware that without such information they could not accurately make the representations alleged in paragraphs 15-22.

63. At the time of the making of these representations, and at all times thereafter, defendants concealed from plaintiffs their lack of information and their consequent inability to make the alleged representations accurately.

64. By their conduct as hereinabove alleged, defendants, and each of them, have breached their obligations to plaintiffs, and plaintiffs have been damaged in each and every respect set forth in paragraph 41 of the First Claim of this Complaint.

65. In committing all of the foregoing acts of misconduct, defendants acted fraudulently, oppressively, maliciously and in flagrant, aggravated, wanton and reckless abuse of the confidence reposed in them by plaintiffs, and plaintiffs are therefore entitled to and demand damages for sake of example and by way of punishment of defendants in the amount of $5,000,000.

XI.

EIGHTH CLAIM
(California Corporations Code)

66. Plaintiffs incorporate by reference paragraphs 1 through 26, and this Court has pendent jurisdiction over this claim.

67. Between November, 1979 and December, 1981 defendants caused to be offered and sold to plaintiffs and did offer and sell to plaintiffs the common stock of TONM, by means of written communication of the untrue statements of material fact and misleading omissions to

state material fact set forth in paragraphs 15-22, in violations of Sections 25400 and 25500 *et seq.* of the California Corporations Code.

68. Defendants knew, at the time the misrepresentations and omissions were made, that they were false and misleading. Defendants intended for plaintiffs to rely on the misrepresentations and omissions in the purchase of the TONM stock.

69. Plaintiffs believed these representations to be true, and in reliance thereon, purchased a substantial amount of TONM stock.

70. As a result of defendants' conduct, as hereinbefore alleged, in violation of Calif. Corp. Code §§ 25400 and 25500 *et seq.*, plaintiffs have been damaged in each and every respect set forth in paragraph 41 of the First Claim of this Complaint.

WHEREFORE, plaintiffs pray against defendants as follows:

1. For general damages in the amount of at least $2,000,000 or such other amount as may be proved at trial.

2. For exemplary damages in the amount of $5,000,000;

3. For costs of suit and attorneys' fees herein;

4. For such other and further relief as the Court deems just and proper.

Dated: December 10, 1982
San Francisco, California

JOHN H. BOONE
GEOFFREY P. KNUDSEN
MICHAEL R. DAVISSON
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By MICHAEL R. DAVISSON
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DEMAND FOR JURY TRIAL

Pursuant to Rule 38(b) of the Federal Rules of Civil Procedure, plaintiffs hereby demand a trial by jury of all issues triable of right by a jury.

Dated: December 10, 1982
San Francisco, California

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(3)

No. 84-679

In the Supreme Court

OF THE

United States

OCTOBER TERM 1984

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED
Petitioner,

VS.

CARL F. BERNER, CHARLES BRUNER, DENNIS T. DEMETRE, LAWRENCE EPSTEIN, BARRY S. GLASS, HERBERT GREENBAUM, ROBERT M. JACOBS, ARNOLD R. KEILES, HARRY MITTLEMAN, GARY L. NOBEL, CHARLES P. LAZZARO, LESLIE L. NEADEAU and T.O.N.M. OIL & GAS EXPLORATION CORPORATION,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF PETITIONER

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QUESTIONS PRESENTED

1. Should the common law *in pari delicto* defense bar implied private fraud actions under the federal securities laws by an admitted tippee-securities law violator against his alleged tipper?

2. Is the availability of the *in pari delicto* defense in actions implied under the securities laws attenuated or eliminated by considerations this Court articulated in its decision in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), examining the availability of the defense in private actions expressly granted by the antitrust laws?

3. If the *in pari delicto* defense applies to implied securities fraud actions, are plaintiffs here barred from proceeding because their conduct was "substantially equal" in fault to that of the defendants?[1]

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[1]Petitioner Bateman Eichler, Hill Richards, Incorporated has the following parent company: Batehill, Inc., which in turn is a wholly-owned subsidiary of Kemper Corporation. Petitioner has no other parent company, subsidiary, or affiliate within the meaning of Supreme Court Rule 28.1.

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CARL F. BERNER, CHARLES BRUNER, DENNIS T. DEMETRE, LAWRENCE EPSTEIN, BARRY S. GLASS, HERBERT GREENBAUM, ROBERT M. JACOBS, ARNOLD R. KEILES, HARRY MITTLEMAN, GARY L. NOBEL, CHARLES P. LAZZARO, LESLIE L. NEADEAU and T.O.N.M. OIL & GAS EXPLORATION CORPORATION,
Respondents.

BRIEF OF PETITIONER

OPINIONS BELOW

The opinion of the Ninth Circuit Court of Appeals rendered April 13, 1984 and amended July 26, 1984 is reported at 730 F.2d 1319 (9th Cir. 1984) and is Appendix A ("Pet. App. A-1") to the petition for certiorari ("petition"). The order of the Ninth Circuit Court of Appeals amending the opinion and denying rehearing and rehearing en banc was entered July 26, 1984 and is Appendix B to the petition. The unreported order of the United States District Court for the Central District of California was entered April 18, 1983 and is Appendix C to the petition ("Pet. App. C-1").

JURISDICTION

The judgment of the Ninth Circuit Court of Appeals was entered on April 13, 1984. A petition for rehearing with a suggestion for rehearing en banc was timely filed on April 30, 1984. The petition for rehearing was denied and the opinion was modified by an undated order entered July 26, 1984. The petition for writ of certiorari, invoking the jurisdiction of the Supreme Court pursuant to 28 U.S.C. § 1254(1) (1982), was timely filed within ninety days thereafter. (28 U.S.C. § 2101(c) (1982); Supreme Court Rule 20.2, 20.4.) This Court granted the petition on January 7, 1985.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

This case involves Section 10(b) of the Securities Exchange Act of 1934 (the "Securities Exchange Act"), 15 U.S.C. § 78j(b) (1982); Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1985); and Section 17(a) of the Securities Act of 1933 (the "Securities Act"), 15 U.S.C. § 77q(a) (1982). These statutory provisions are printed in full in the appendix to this Brief ("Brief App.") at A-1-2.

The issues presented also are affected by Section 16 of the Securities Act, 15 U.S.C. § 77p (1982); Section 28(a) of the Securities Exchange Act, 15 U.S.C. § 78bb(a) (1982); and the provisions of the recently enacted Insider Trading Sanctions Act of 1984, 1984 U.S. Code Cong. & Ad. News (98 Stat.) 1264, to be codified at Section 21(d) of the Securities Exchange Act, 15 U.S.C. § 78u(d). Section 16 of the Securities Act, 15 U.S.C. § 77p (1982), states:

> The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity.

Section 28(a) of the Securities Exchange Act, 15 U.S.C. § 78bb(a) (1982), contains the same provision. The provisions of the Insider Trading Sanctions Act are printed in full at Brief App. A-2-6.

The issues in this case also may be affected by Section 4 of the Clayton Act of 1914, 15 U.S.C.A. § 15 (West Supp. 1984), which states:

> [A]ny person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States in the district in which the defendant resides or is found or has an agent, without respect to the amount in controversy, and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee.

STATEMENT OF THE CASE

Plaintiffs, admitted tippee-stock purchasers, allege that they obtained tips of actual and supposed material inside information on a public company from a representative of a broker-dealer. They then acted to confirm the tips with a corporate insider whom they understood to be the original source. Thereafter, believing they had confirmed the tips, they repeatedly defrauded innocent sellers of the stock by buying "substantial amounts" of the stock without disclosing the information they had unlawfully obtained. Disappointed that their scheme did not prove profitable, plaintiffs then sued to recover their anticipated but unrealized profits and to recoup their losses from their alleged tippers on the premise that the tips were false or misleading.

The district court dismissed the complaint on the ground that plaintiffs had themselves violated the securities laws

by these acts, and therefore the doctrine of *in pari delicto* barred their claims. (Pet. App. C-2). The Court of Appeals for the Ninth Circuit reversed the dismissal, thereby enabling these plaintiffs to utilize the process of the federal courts to secure the fruits of their own fraud free of the *in pari delicto* defense.

The complaint presents claims for violation of federal and state securities laws and state statutory and common law fraud. The only claims at issue here are one under Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b) (1982), and Rule 10b-5, 17 C.F.R. 240.10b-5 (1985), and one under Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a) (1982).[2] Jurisdiction of the district court was invoked under Section 22 of the Securities Act, 15 U.S.C. § 77v (1982), and Section 27 of the Securities Exchange Act, 15 U.S.C. § 78aa (1982).

The complaint sets forth all the facts necessary for application of the *in pari delicto* defense.[3] It alleges that plaintiffs purchased the publicly traded stock of T.O.N.M. Oil & Gas Exploration Corporation ("T.O.N.M.") expressly "on the premise" that information plaintiffs had received from

[2]The Ninth Circuit affirmed the district court's dismissal of an additional purported federal securities law claim under Section 15 of the Securities Exchange Act, 15 U.S.C. § 78o (1982), which is not in issue here.

[3]An assessment of the availability of an *in pari delicto* defense requires an analysis of the relative culpability of the plaintiff and the defendant. Because the complaint pleaded the facts underlying plaintiffs' violations of the securities laws in unusual detail, the district court was able to weigh the relative culpability of the plaintiff and the defendants in the context of Bateman Eichler, Hill Richards, Incorporated's motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6) without requiring any fuller factual development. In another context, this Court has done the same and found an absence of justiciable controversy when pleadings alone were sufficiently detailed to present an *in pari delicto* issue in an appropriate posture for review. *See, e.g., The St. Louis, Vandalia & Terre Haute R. Co. v. The Terre Haute & Indianapolis R. Co.*, 145 U.S. 393, 408 (1891) (on appeal from dismissal of bill in equity, facts showed parties were *in pari delicto*).

Charles Lazzaro, a Bateman Eichler, Hill Richards, Inc. ("BEHR") broker, was "information not otherwise available to the general public." (Complaint ¶ 15; Joint Appendix ("Jt. App.") at 10.)

According to the complaint, Lazzaro induced plaintiffs to purchase T.O.N.M. stock by telling them that he knew T.O.N.M.'s president and/or vice-president personally and that he had learned the following non-public information about the company: T.O.N.M. had acquired rights to a large gold deposit discovered in Surinam; it was about to enter into a joint venture agreement with a large mining company to mine the gold; it would issue to its shareholders stock in its subsidiary without additional consideration; and for these reasons the value of T.O.N.M. stock would increase dramatically from $1.50 per share to between $10

Other courts presented with complaints detailing sufficient facts to provide the basis for an analysis of relative culpability have decided the availability of the *in pari delicto* defense to securities claims at the pleading stage. *See, e.g., In re Haven Industries, Inc.*, 462 F. Supp. 172, 173, 178-80 (S.D.N.Y. 1978) (upholding *in pari delicto* defense raised in motion to dismiss pursuant to Fed.R.Civ.P. 12(b)(6) and motion for summary judgment pursuant to Fed.R.Civ. P. 56 by reference to allegations of complaint establishing plaintiffs' own violations); *see also Grumet v. Shearson/American Express, Inc.*, 564 F. Supp. 336, 341 n.3 (D.N.J. 1983) (entering summary judgment for defendants based upon *in pari delicto* doctrine and denying additional discovery because "allegations of the complaint are sufficient for purposes of analysis of the *in pari delicto* defense").

and $15 per share when T.O.N.M. publicly released the information. (Complaint ¶¶ 16-18; Jt. App. 11-12.) Lazzaro also told plaintiffs that he and his relatives owned, and were holding throughout the period relevant to the complaint, a large block of T.O.N.M. stock. (Complaint ¶ 16(i); Jt. App. 12.)[4]

[4]The complaint detailed Lazzaro's alleged representations as follows:

> a. Vast amounts of gold had been discovered in Surinam, and TONM had options on thousands of acres in gold-producing regions of Surinam.
>
> b. The find had been verified by geological reports and the find compared favorably to, if not better than, those in South Africa.
>
> c. The presence of the find and the geological report(s) were not publicly known, but would subsequently be announced.
>
> d. The development of the Surinam gold fields would not require deep mining. Geologists in Surinam were finding gold nuggets in dry creek beds.
>
> e. TONM was negotiating with the St. Joseph Mining & Mineral Company, and possibly other large companies, from as early as February, 1980, to engage in a joint venture to mine the gold in Surinam.
>
> f. The St. Joseph Mining & Mineral Company was to invest two hundred million dollars to mine the gold in Surinam.
>
> g. After that announcement, Lazzaro stated that TONM stock would go up 6-11 points. Thus, TONM stock, which was then selling from $1.50 to $3.00/share, would increase in value to $10 to $15/share within a short period of time, and that [sic] it might increase to $100/share by the end of 1980.
>
> h. TONM shareholders would *automatically* receive 1 share of IGDE for every 5 shares of TONM stock without the payment of any additional monies.
>
> i. Lazzaro and his relatives owned a large block of TONM stock, and neither Lazzaro nor any of his relatives were, at any time, selling their TONM stock.

(Complaint ¶ 16; Jt. App. 11-12.)

Plaintiffs did not passively rely on this information. Instead, they undertook to confirm it before commencing a purchasing plan which required, for its success, that plaintiffs withhold these "tips" from the other parties to their trades. Plaintiffs thus contacted T.O.N.M. president Leslie Neadeau to verify the accuracy of their "tips," but Neadeau would neither confirm nor deny them. Significantly, plaintiffs did learn from Neadeau, however, that such information was "not public knowledge" and that Lazzaro was "very trustworthy and a good man." (Complaint ¶ 19; Jt. App. 12.)[5]

With confidence that they possessed inside information and could obtain stock from unwitting sellers at a fraction

The Complaint further stated:

> Lazzaro represented that he knew personally the President and/or Vice-President of TONM and TONM was going to announce publicly by April, 1980, that St. Joseph's Mineral & Mining Company was entering into a joint venture with TONM.

(Complaint ¶ 17; Jt. App. 12.)

[5]The complaint described plaintiffs' conversation with Neadeau, in which plaintiffs implicitly verified Lazzaro's claims, as follows:

> 19. In or about April, 1980, certain plaintiffs contacted Leslie L. Neadeau, President of TONM, to attempt to verify Lazzaro's claims concerning the Surinam gold find and whether TONM was going to enter into a joint venture agreement with St. Joseph Mining & Mineral Company or with any other company for the exploration and mining of gold in Surinam. Mr. Neadeau would neither confirm nor deny those claims, stating that they were not public knowledge and that plaintiffs would have to wait for the publication of TONM's annual report. Mr. Neadeau was specifically advised that plaintiffs were dealing with Lazzaro, and Mr. Neadeau told the plaintiffs that he could say that Lazzaro was very trustworthy and a good man.

(Complaint ¶ 19; Jt. App. 12.)

of its true value, plaintiffs then purchased T.O.N.M. stock in the public markets from November 1979 through much of 1980 without disclosing the information to the sellers. (Complaint ¶¶ 15, 24; Jt. App. 10, 14.) These were not casual purchasers. Rather, they engaged in a studied scheme to defraud. Throughout, plaintiffs believed that they were trading, and in fact they admit that they did trade, on material non-public information, which they knew came from Neadeau. Meanwhile, the price of T.O.N.M. stock did rise to $7 per share in late 1980. Then, with public news that the negotiations between T.O.N.M. and its prospective joint venturer had terminated and that no new negotiations were contemplated, the stock fell sharply to less than $1 per share in the second quarter of 1981. (Complaint ¶¶ 20, 25; Jt. App. 13, 14.)

Plaintiffs, unwilling to bear the losses their illegal conduct occasioned, sought by this suit to recover their losses and their anticipated profits from their alleged tippers on the basis that some of the non-public information was false or incomplete. Defendants BEHR and Lazzaro moved to dismiss the complaint under Federal Rule of Civil Procedure 12(b)(6).[6] In ruling on that motion, the United States District Court for the Northern District of California (District Judge William W. Schwarzer) necessarily accepted as true the material, well-pleaded allegations of plaintiffs' complaint. *See Miree v. DeKalb County*, 433

[6]Defendants T.O.N.M. and Neadeau, who held approximately 100,000 T.O.N.M. shares, were not parties to BEHR's and Lazzaro's motion to dismiss.

T.O.N.M. is presently a debtor in possession pursuant to a Chapter 11 proceeding in the United States Bankruptcy Court for the Central District of California, *In re T.O.N.M. OIL & GAS EXPLORATION CORPORATION, a New Mexico Corporation*, No. LA 84-13915-CA (filed June 29, 1984).

U.S. 25, 27 n.2 (1977).[7] These detailed allegations established that plaintiffs traded upon what they believed to be material inside information originating with a corporate officer who was duty-bound not to release that information for personal gain.

Concluding that plaintiffs had themselves violated the securities laws they charged defendants with violating, the district court dismissed the suit as to all defendants. This dismissal was based on the then-unanimous law of the federal courts of appeals, as articulated most specifically in decisions of the Third and Fifth Circuit Courts of Appeals, denying to such plaintiffs a judicial remedy to obtain the benefits of their own violation of the federal securities laws. (Pet. App. C-2.)

Plaintiffs appealed the dismissal to the Ninth Circuit Court of Appeals, and the Securities and Exchange Commission ("SEC") filed a brief as amicus curiae and presented oral argument there. The Ninth Circuit Court of Appeals reversed and held that these tippees, who wilfully traded on material inside information with an intent to defraud innocent investors, nevertheless are immune from the bar of the *in pari delicto* defense in a lawsuit against a broker and a corporate insider. The court below explicitly recognized that it had "reached a result in this matter which is contrary to the views expressed in *Tarasi v. Pittsburgh National Bank*, 555 F.2d 1152 (3d Cir. 1977), *cert. denied*, 434 U.S. 965, 98 S. Ct. 504, 54 L.Ed.2d 451 (1971), and *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969)." (Pet. App. A-10; 730 F.2d at 1324.) The court did not mention the decisions of the Eleventh and Fourth Circuit Courts of Appeals, which upheld the availability of the *in pari delicto* defense. *See Silverberg v. Paine, Webber, Jackson & Curtis, Inc.*, 710 F.2d 678 (11th Cir. 1983), con-

[7]Defendants Lazzaro and BEHR deny the truth of plaintiffs' charges. However, of course, the allegations are assumed to be true, *arguendo*, in the context of a motion to dismiss.

cluding that the *in pari delicto* defense was available in securities cases although the facts of that particular case did not warrant applying the defense, and *Malamphy v. Real-Tex Enterprises, Inc.*, 527 F.2d 978 (4th Cir. 1975), approving application of the *in pari delicto* defense against an investor asserting common law claims.

Even though the court of appeals below acknowledged that the plaintiffs-tippees in the present case and in *Tarasi* and *Kuehnert* also "violated the federal securities laws," the court, without any analysis of plaintiffs' conduct here or there, rejected what it characterized as those courts' conclusion that "a duped investor is equally at fault in the fraud perpetrated against him by his broker or an insider." (Pet. App. A-10-11; 730 F.2d at 1324.) Plaintiffs, of course, were not "duped investors" but rather were themselves active and eager participants in a fraud on innocent investors. Furthermore, defendant brokers and corporate insiders owe the same duty under Rule 10b-5 to the securities markets as do "any person[s]," including tippees like plaintiffs who trade knowing they improperly have obtained material, non-public information.

The court of appeals' decision rested on a second error as well: the premise that in the securities law context, "[p]ublic policy encourages private actions as enforcement devices for the public interest, even though a windfall may accrue to a wrongdoing plaintiff." (Pet. App. A-4-5; 730 F.2d at 1321.) The court of appeals reached this conclusion by mistaken reliance on *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), where this Court restricted the circumstances under which the *in pari delicto* defense might be applied to bar statutorily created "private attorney general" antitrust actions. The court of appeals ignored the crucial differences between actions under such express enforcement provisions of the federal antitrust laws and implied actions under the securities fraud laws, which are discussed in full in Section II.C.2.

The court simply assumed that implied private actions by persons in the position of plaintiffs were necessary to serve the market-protecting aims of the Securities Act and the Securities Exchange Act (Pet. App. A-7-8; 730 F.2d at 1322-23), without considering the intent of Congress, the harm that would inure to the judicial system as a result of providing a forum for relief to wrongdoers, or the adverse impact its conclusion would impose on the securities markets by dramatically reducing the risks assumed by tippees who knowingly trade on inside information.

SUMMARY OF ARGUMENT

The principle of *in pari delicto*, deeply rooted in English and American common law, directs courts to leave parties as they find them when, as here, a plaintiff and defendant come before the court in a condition of substantially equal fault. That principle, which preserves the integrity of the judicial process and discourages wrongdoing, was incorporated into the securities laws when Congress enacted them against a background of common law tradition and expressly preserved common law rights and remedies. The courts have more fully drawn the doctrine into the securities regulatory scheme by relying on common law principles in implying a private right of action under certain sections of the securities laws, including Section 10(b) of the Securities Exchange Act, that did not expressly provide one.

In *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), this Court fashioned a judicial limitation on the application of the *in pari delicto* defense in statutorily created private antitrust actions. That limitation was consistent with the doctrine as it had developed at common law — barring the defense where plaintiff's conduct was much less culpable than defendant's or where a statute operated to override the defense. Both the letter and spirit of the *Perma Life* decision dictate the preservation and invocation of the *in pari delicto* defense here.

Unlike the *Perma Life* plaintiffs, plaintiffs here have without any coercion — indeed eagerly and repeatedly — violated the securities laws by defrauding innocent investors. They admittedly did so by trading without disclosing actual and supposed material non-public information they knew was wrongfully obtained. Their *delictum*, as pleaded, is thus at least *par* with defendants.

Also unlike the *Perma Life* plaintiffs, plaintiffs here are not presenting claims based upon a statute which can be said to override the common law defense. The federal securities provisions relied upon by plaintiffs, which expressly grant no private right of action, naturally do not reflect any Congressional intention to give private actions preeminence over common law rights and defenses. To the contrary, the right to bring such actions under Section 10(b) and Rule 10b-5 is implied by reference to the same common law that creates and preserves the *in pari delicto* defense. The common law, in contrast, did not provide a private right of action for victims of antitrust violations in the years pre-dating the Sherman Antitrust Act. There thus is no basis to conclude that any congressional policy encouraging enforcement of the federal securities laws through implied private actions even exists, much less that it can or should predominate over the traditional strong interest of the courts in protecting their own integrity by refusing to provide a forum where wrongdoers can reap the fruits of their misdeeds.

ARGUMENT

I

PLAINTIFFS HAVE ALLEGED CONDUCT WHICH REVEALS THAT THEY HAVE VIOLATED THE VERY LAWS UPON WHICH THEIR CLAIMS DEPEND.

The complaint is rife with allegations that show plaintiffs' conduct was grossly culpable under the federal

securities laws. Plaintiffs have admitted that (1) they believed, after seeking actively to confirm it, that they had material inside information about a stock, (2) they did in fact have inside information, and (3) they knew this information came from a high-ranking insider. They also admitted that, acting with scienter, they fraudulently failed to reveal that information when they traded with investors who only had access to public information about the stock.

Plaintiffs' conduct places them squarely within the class of parties required to disclose inside information by this Court's decisions in *Chiarella v. United States*, 445 U.S. 222 (1980), and *Dirks v. S.E.C.*, ___ U.S. ___, 103 S. Ct. 3255 (1983). In *Chiarella*, this Court held that no duty to disclose material, non-public information prior to trading arises under Rule 10b-5 if the trader has not obtained the information by breach of a fiduciary duty he owes to corporate shareholders. In *Dirks*, this Court expanded upon its decision in *Chiarella* and held that the duty of a tippee to disclose or abstain from trading on inside information derives from the fiduciary duty that the insider tipper owes the corporation's shareholders. 103 S. Ct. at 3264. This Court established a test for measuring breach of fiduciary duty by inquiring into whether the tipping insider secured a direct or indirect personal gain. This test focuses upon "objective criteria" such as "pecuniary gain or a reputational benefit that will translate into future earnings." *Id.* at 3265-66 (citing *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n.15 (1961)).[9]

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[9]Corporate insiders also are forbidden under Section 10(b) from making a gift of inside information. *Dirks v. S.E.C.*, *supra*, 103 S. Ct. at 3263.

Where an insider does not tip for an improper purpose, a tippee does not breach his derivative duty when he trades. *Id.* at 3265-66. But when, as here, a tippee knows that the insider has tipped for an improper purpose, the tippee does acquire a derivative duty not to trade. This Court made the point in *Dirks*:

> Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain. *See* 15 U.S.C. § 78t(b) (making it unlawful to do indirectly "by means of any other person" any act made unlawful by the federal securities laws). Similarly, the transactions of those who knowingly participate with the fiduciary in such breach are "as forbidden" as transactions "on behalf of the trustee himself."

Id. at 3263.

This Court's opinion continued:

> Thus, a tippee assumes the fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

Id. at 3264.

Plaintiffs' admissions here establish repeated violations of their duty not to trade. Plaintiffs learned material inside information from Lazzaro, who represented that he knew personally the president, Neadeau, and/or vice-president of T.O.N.M. (Complaint ¶ 17; Jt. App. 12.)[9] Plain-

[9]Neadeau and T.O.N.M. allegedly also conspired with Lazzaro to manipulate the market for T.O.N.M. stock, which Neadeau, Lazzaro and members of his family held in substantial quantities. (Complaint ¶¶ 8, 9, 16(i); Jt. App. 8, 12.)

tiffs checked with Neadeau, who advised them that the information was non-public (hence they knew they should not have received it and must not trade on it) and who implicitly affirmed that Lazzaro was to be trusted in passing along non-public information. (Complaint ¶ 19; Jt. App. 12). Plaintiffs thus knew that Lazzaro's information came from an insider who had a duty not to disclose the information but who did disclose it for a wrongful purpose of personal gain and in all events in derogation of his duty to treat shareholders of his company fairly. *See Zahn v. Transamerica*, 162 F.2d 36, 46-47 (3rd Cir. 1947). For that matter, plaintiffs also knew that the broker stood to benefit personally from his substantial holdings in T.O.N.M. and right to commissions. (Complaint ¶ 16(i); Jt. App. 12). Accordingly, plaintiffs inherited the insider's duty not to trade on that non-public information and cannot escape the conclusion that they violated the securities laws. Hence, the doctrine of *in pari delicto* bars their claims.

Plaintiffs may contend, however, that certain of defendants' representations detailed in the complaint were untrue. This argument fails for two reasons. First, the complaint apparently is predicated on the theory that while Lazzaro failed to disclose some material facts, certain of his inside information was true. Thus, plaintiffs do not allege that they did not receive any real inside information at all. Indeed, they concede that they did trade on true inside information, that there was a gold find, and that negotiations between T.O.N.M. and a mining company for a joint venture were underway. Plaintiffs pleaded specifically that in January 1981, "TONM announced that the negotiations for a joint venture [to mine the gold]

had terminated and that no new negotiations were contemplated." (Complaint ¶ 20; Jt. App. 13.)[10]

Second, if plaintiffs are alleging that they did not in fact receive any inside information, plaintiffs nonetheless violated the securities laws when they traded on what they believed to be improperly acquired material inside information but did not disclose that information to the other parties to their trades. *See James v. DuBreuil,* 500 F.2d 155, 159-60 (5th Cir. 1974). Plaintiffs' acts fall squarely within the language of Section 10(b) of the Securities Exchange Act, which refers to "any manipulative or deceptive device" and hence encompasses attempted frauds as well as completed frauds. *Kuehnert v. Texstar Corp.,* 412 F.2d 700, 714 (5th Cir. 1969). Plaintiffs' violation of Rule 10b-5 is established, as well, because the Rule extends "to attempted as well as consummated frauds." *Tarasi v. Pittsburgh National Bank,* 555 F.2d 1152, 1159-60 (3rd Cir.), *cert. denied,* 434 U.S. 965 (1977); *Grumet v. Shearson/American Express, Inc.,* 564 F. Supp. 336, 340 (D.N.J. 1983). This is true because subsection (a) of Rule 10b-5 prohibits any "scheme" to defraud, and subsection (c) prohibits any practice that "would operate" as a fraud or deceit. *Grumet v. Shearson/American Express, supra,* 564 F. Supp. at 340.

In determining whether plaintiffs should be barred from suit by the *in pari delicto* defense, it is immaterial in any event whether plaintiffs succeeded in actually violating the securities laws. The controlling factor is that plaintiffs intended to commit fraudulent acts that would have been

[10]Plaintiffs are also liable for securities law violations under a misappropriation theory. *See Chiarella v. United States, supra,* 445 U.S. at 240 (Burger, C. J., dissenting). But under any formulation of the prohibition against insider trading, the objective facts pleaded are sufficient to prevent any claim by plaintiffs that their conduct was benign under the existing *Dirks* standard.

harmful to the securities markets.[11] They may not recover damages simply because their illegal plot was unsuccessful.[12]

[11]The principle that attempts to commit illegal acts equate with successful performance of such acts for purposes of the *in pari delicto* defense is discussed further in Section II A.1 of this brief.

[12]*Cf. Silverberg v. Paine, Webber, Jackson & Curtis, Inc.,* 710 F.2d 678, 691 (11th Cir. 1983) (denying *in pari delicto* defense where broker was not an insider and hence plaintiff inherited no *Chiarella/Dirks* duty to disclose); *Schick v. Steiger,* 583 F. Supp. 841, 847-48 (E.D. Mich. 1984) (denying *in pari delicto* defense on theory that tippees did not acquire duty to disclose from insider who originated tip regarding potential takeover that ultimately failed to materialize); *Xaphes v. Shearson, Hayden, Stone, Inc.,* 508 F. Supp. 882, 886 (S.D. Fla. 1981) (holding that *in pari delicto* defense did not apply to a would-be tippee's Rule 10b-5 claim because broker's customer was not a tippee with a duty to disclose because his broker, who misrepresented to plaintiff customer that he was an insider, in fact was not). The facts in *Xaphes* are distinguishable from the case surrounding Lazzaro's purported tip to plaintiffs here, because the broker here indicated that the "inside" information came from the president or vice-president of the affected corporation and because plaintiffs directly contacted T.O.N.M. president Neadeau in an attempt to verify the information and confirmed with him that the information was "inside" information. (Complaint ¶ 19; Jt. App. 12.) While the broker in *Xaphes* claimed to be an insider as broadly defined (someone with access to material, inside information), *id.* at 884-85 n.3, he did not claim to be and was not a real *Chiarella/Dirks* "insider" with a fiduciary relationship or a "special confidential relationship" with corporate shareholders. *Chiarella, supra,* 445 U.S. at 230, 232; *Dirks, supra,* 103 S. Ct. at 3281 n.14.

The doctrine of "legal impossibility" could provide an absolute defense to a prosecution of plaintiffs in both *Xaphes* and *Silverberg,* because their conduct, even under the facts as they believed them to be, was not unlawful under the securities laws. Petitioner submits that the conclusion of the court in *Schick* that plaintiff there was not liable under *Dirks* was incorrect, however. The court failed to recognize that the tippees had acquired a deriva-

II

THE COMMON LAW DEFENSE OF *IN PARI DELICTO*, BARRING A PLAINTIFF GUILTY OF SUBSTANTIALLY EQUAL FAULT, MAY BE ASSERTED AS A DEFENSE TO PRIVATE ACTIONS IMPLIED FROM FEDERAL SECURITIES LAWS.

A. The Defense of *In Pari Delicto* is a Sound Historical Expression of Policy Protecting the Integrity of the Judicial Process.

1. The Defense Has Been Applied Continuously Since the Earliest Days of Common Law to Bar a Plaintiff Who Has Committed An Unlawful Act or Has Attempted to Do So.

From the earliest days of common law, the courts have refused to aid plaintiffs whose conduct is equally culpable to that of those they seek to sue under the theory that "[h]e who comes here for relief must draw his justice from pure fountains," *Austin's Adm'x v. Winston's Ex'r*, 11 Va. (1 Hen. & M.) 32, 47 (1806). *See, e.g., Creath's Administrator v. Sims*, 45 U.S. 192 (1847); *Holman v. Johnson*, 1 Cowp. 341, 98 Eng. Rpts. 1120 (1775). The roots of this *in pari delicto* doctrine and its application in our legal

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tive duty to disclose from their insurance broker tipper who had received the tip from a close friend who was a member of the founding family of the target corporation. The defendant either derivatively or directly had acquired a duty to disclose from his insider-tipper, and he tipped the plaintiffs for the purpose of financial gain: a rise in the price of the "target" company's stock, a large quantity of which he had purchased himself. *See Dirks*, 103 S. Ct. at 3266. Plaintiffs in *Schick* knew that the "tip" had originated with a corporate insider and that the passage of the tip from corporate insider to insurance broker and from insurance broker to them each breached the respective tipper's fiduciary duty.

system run deep in both English and American decisional law.[13]

The doctrine of *in pari delicto* literally means "of equal fault" and stems from the Latin expression *"in pari delicto potior est conditio defendentis"* ("in a case of mutual fault, the condition of the party defending is the better one"). *Black's Law Dictionary* 711 (rev. 5th ed. 1977). As the doctrine has evolved, the federal courts now require fault to be substantially equal. *See, e.g., Wolfson v. Baker*, 623 F.2d 1074, 1082 (5th Cir. 1980); *James v. DuBreuil*, 500 F.2d 155, 160 (5th Cir. 1974).

Courts have invoked the *in pari delicto* defense in response to a wide variety of unlawful acts, ranging from bribery (*Clark v. United States*, 102 U.S. 181 (1880)) through secret collaboration on a purportedly competitive bid for a public contract (*McMullen v. Hoffman*, 174 U.S. 639 (1898)) to perjury committed to procure homestead lands (*Anderson v. Carkins*, 135 U.S. 483 (1890)). Those cases most pertinent here have involved fraudulent misconduct, which has often provided the basis for application of the defense. *See, e.g., Meguire v. Corwine*, 101 U.S. 108, 111-12 (1880) ("Frauds, of the class to which the one here disclosed belongs, are an unmixed evil. Whether forbidden by a statute or condemned by public policy, the result is the same. No legal right can spring from such a

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[13]The defense was imported from England, where it was articulated by Lord Mansfield as early as 1775 in *Holman v. Johnson*, 98 Eng. Rep. 1120 (1775), and it was firmly implanted in American common law by the end of the nineteenth century, *see St. Louis, Vandalia & Terre Haute R. Co. v. Terre Haute & Indianapolis R. Co.*, 145 U.S. 393 (1801); *Thomas v. City of Richmond*, 79 U.S. (12 Wall.) 349 (1870); *Hannay v. Eve*, 7 J.S. (3 Cranch) 242, 247-49 (1806). Cases construing the defense in the state courts are collected in the petition at 11 n.6.

source."); *McMullen v. Hoffman, supra,* 174 U.S. at 670 ("Being of the opinion that the contract approved in this case was illegal in the sense that it was fraudulent, and entered into for improper purposes, the law will leave the parties as it finds them.").

As might be expected from a defense which focuses upon the immorality of the plaintiff's own conduct, the *in pari delicto* defense is applied both where the plaintiff is guilty of a completed act of malfeasance, *see, e.g., Higgins v. McCrea,* 116 U.S. 671 (1886) (gambling); *Clark v. United States, supra,* 102 U.S. 181 (bribery), and where the plaintiff's misconduct amounts only to an attempt to commit an illegal act, *see, e.g., McMullen v. Hoffman, supra,* 174 U.S. 639; *Scott v. Brown,* 2 Q.B. 724 (1892). The application of the doctrine to an attempt was perhaps first explained in *King v. De Berenger,* 3 Maule & S. 67, 72 (1814) where the court noted that the "purpose [of a conspiracy to raise securities prices] is mischievous" and that the "crime lies in the act of . . . combination to effect that purpose." The court applied the *De Berenger* doctrine in *Scott v. Brown, supra,* to reject a plaintiff's claims that, although he had bought shares at a premium as part of a conspiracy to inflate their market price, he had not committed a wrongful act in making open market purchases. The court centered upon plaintiff's intent and barred his action. 2 Q.B. at 734 (A.L. Smith, L.J.).

This Court adopted the same reasoning when it faced the question in *McMullen v. Hoffman, supra.* This Court there noted, "The vice is inherent in contracts of this kind, and its existence does not in the least depend upon the success which attends the execution of any particular agreement." 174 U.S. 648.

2. The Defense Is Based upon Sound Policy Doctrines of Protection of Judicial Integrity and Deterrence by Denying Rewards to Wrongdoers.

Twin policies of judicial integrity and deterrence have motivated courts from the earliest days of the common law to fashion and to employ the *in pari delicto* defense. Maintenance of judicial integrity requires careful attention to the respectability of the courts, which must not become tainted by facilitating illegal transactions. This wisdom has not been eroded by time; public confidence in the judicial process is surely as imperative today as it ever was.

This policy also seeks to relieve courts from using their increasingly overtaxed resources[14] to sort out relative "justice" among admitted wrongdoers whose complaints stem from their own violations of the law. In *Higgins v. McCrea,* 116 U.S. 671 (1886), this Court implicitly acknowledged that such use of its processes would be hypocritical:

> We do not see on what ground a party who says in his pleading that the money which he seeks to recover was paid out for the accomplishment of a purpose made an offense by the law, and who testifies and insists to the end of his suit that the contract on which he advanced his money was illegal, criminal, and void, can recover it back in a court whose duty it is to give effect to the law which the party admits he intended to violate.

116 U.S. at 685.

The doctrine therefore is applied without regard to individual fairness, resting instead on the societal interest

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[14]"The courts are presently heavily burdened and becoming increasingly so. The scarcity of judicial resources relative to demand of litigants is bordering on the unmanageable. Chief Justice Warren E. Burger, 1984 Year-End Report on the Judiciary (December 31, 1984).

in lawful conduct. As Lord Mansfield wrote in *Holman v. Johnson*, 1 Cowp. 341, 98 England Rpts. 1120 (1775):

> The [*in pari delicto* defense] sounds at all times very ill in the mouth of the defendant. It is not for his sake, however, that the objection is ever allowed; .... The principle of public policy is this; ex dolo malo non oritur actio. (Out of fraud no action arises.).... It is upon that ground the Court goes; not for the sake of the defendant, but because they will not lend their aid to such a plaintiff.

1 Cowp. at 343.

The second policy supporting *in pari delicto*, that of deterrence, was articulated early in this Court's history, in *McMullen v. Hoffman*, 174 U.S. 639 (1898):

> To refuse to grant either party to an illegal contract judicial aid for the enforcement of his alleged rights under it tends strongly towards reducing the number of such transactions to a minimum. The more plainly parties understand that when they enter into contracts of this nature they place themselves outside the protection of the law, so far as that protection consists in aiding them to enforce such contracts, the less inclined will they be to enter into them. In that way the public secures the benefit of a rigid adherence to the law.

174 U.S. at 669-70.

B. Common Law Defenses Such as *In Pari Delicto* Have Been Applied by the Courts of the United States in Securities Actions Since Passage of the Securities Laws.

Common law and equitable defenses are well embedded in the body of decisional securities law. Not only has a plaintiff's willful participation in conduct violating

federal securities laws barred relief on grounds of unclean hands or equal fault,[15] but also plaintiffs have been denied relief on the basis of defenses involving less serious taint such as laches, waiver, estoppel and ratification.[16] As stated in *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 213-14 (9th Cir. 1962):

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[15]*See, e.g., James v. DuBreuil*, 500 F.2d 155, 159-60 (5th Cir. 1974) (barring plaintiff's Securities Act Section 12 claim where plaintiff actively participated in fraudulent transaction designed to violate an SEC rule prohibiting inside trading of stock within a certain period of an announced merger); *Gaudiosi v. Mellon*, 269 F. 2d 873 (3d Cir. 1959) (proxy violations barred relief to all plaintiffs where only one plaintiff had unclean hands); *Chris-Craft Industries, Inc. v. Independent Stockholders Committee*, 354 F. Supp. 895 (D. Del. 1973) (unclean hands doctrine applies in private suit for violation of Securities Exchange Commission proxy rules); *Sankin v. 5410 Connecticut Avenue Corporation*, 281 F. Supp. 524 (D.D.C. 1968) (complaint for declaratory relief, accounting and damages dismissed on basis of unclean hands doctrine where complainants had conspired with majority shareholders to defraud minority shareholders), *cert. denied*, 396 U.S. 1041 (1970).

[16]*See, e.g., Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 171-73 (10th Cir. 1974) (court of appeals declined to find laches on the pleadings and remanded to consider defense at trial); *Fey v. Walston & Co.*, 493 F.2d 1036, 1049 (7th Cir. 1974) (defenses of waiver and estoppel available in action under Securities Exchange Act); *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 373-4 (1st Cir.) (plaintiff estopped from claiming he was investor rather than trader with respect to his allegations of churning), *cert. denied*, 414 U.S. 1002 (1973); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1207-09 (9th Cir. 1970) (laches and estoppel barred plaintiff's claim for damages resulting from alleged churning of account); *Baumel v. Rosen*, 412 F.2d 571, 574-75 (4th Cir. 1969) (adhering to traditional doctrine that action for rescission must be brought without delay), *cert. denied*, 396 U.S. 1037 (1970); *Gordon v. Burr*, 366 F. Supp. 156, 170-71 (S.D.N.Y.

"There is nothing in the language of Section 77*l* [15 U.S.C.] or its legislative history to indicate that Congress intended to create a right enforceable in law or in equity not subject to defenses available at law or in equity to an action based on a voidable contract. The silence of Congress cannot be construed as an intention to make such defenses unavailable."

. . . .

. . . . Since civil liability was judicially implied [under Section 10(b)], the appropriate common law defenses should be applicable. . . . *Since courts generally interpet statutes in the context of the common law and Congress has not specifically denied the availability of these defenses, we see no reason why the ordinary defenses of estoppel and waiver should not be applicable.* The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act.

Id. at 213-14 (emphasis supplied) (quoting *Straley v. Universal Uranium and Milling Corp.*, 312 F.2d 370, 373-74 (9th Cir. 1962)).

1973) (defense of laches is available to defeat action for rescission of stock sold by fraudulent misrepresentations), *aff'd in part, rev'd in part on other grounds*, 506 F.2d 1080 (2d Cir. 1974); *Walpert v. Bart*, 280 F. Supp. 1006, 1017 (D. Md. 1967) (laches available to bar action for accounting and rescission), *aff'd*, 390 F.2d 877 (4th Cir. 1968); *Tobacco and Allied Stock, Inc. v. Transamerica Corporation*, 143 F. Supp. 323, 327-28 (D. Del. 1956) (defendant allowed to assert laches if circumstances warrant), *aff'd*, 244 F.2d 902 (3d Cir. 1957); *Carr v. Warner*, 137 F. Supp. 611, 614-15 (D. Mass. 1955) (plaintiff's claim barred for failure to complain of facts of which plaintiff was aware).

Until the decision of the Ninth Circuit Court of Appeals below, the courts of appeals that had addressed the question as a matter of law had consistently concluded that when a tippee trades on what he believes to be material non-public information improperly acquired, the *in pari delicto* defense can and should bar the tippee's suit against his purported tipper. *See, e.g., Wolfson v. Baker*, 623 F.2d 1074 (5th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981); *Tarasi v. Pittsburgh National Bank*, 555 F.2d 1152 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977); *Malamphy v. Real-Tex Enterprises, Inc.*, 527 F.2d 978 (4th Cir. 1975); *James v. DuBreuil*, 500 F.2d 155 (5th Cir. 1974); *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969).[17]

Application of these traditional defenses by federal courts has been consistent with this Court's acceptance of

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[17]In addition, most of the district courts which have undertaken a policy analysis and decided the availability of the *in pari delicto* defense under the securities laws in tippee versus tipper lawsuits have refused to permit a tippee to avoid the defense when he trades on what he believes to be material non-public information improperly acquired and then attempts to sue his tipper. *Compare, e.g., Grumet v. Shearson/American Express, Inc.*, 564 F. Supp. 336 (D.N.J. 1983); *Kirkland v. E.F. Hutton and Co., Inc.*, 564 F. Supp. 427 (E.D. Mich. 1983); *In re Haven Industries, Inc.*, 462 F. Supp. 172 (S.D.N.Y. 1978); and *Summerlin v. Blyth, Eastman Dillon & Co.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197, at 95,787 (N.D. Ga. 1983), which have upheld the availability of the defense, *with Moholt v. Dean Witter Reynolds, Inc.*, 478 F.Supp. 451 (D.D.C. 1979); and *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F.Supp. 50 (S.D.N.Y. 1971), the district courts which rejected it. *See also Meredith v. Bear, Stearns & Co.*, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,598, at 97,355 (D.D.C. Dec. 6, 1983) (following *Moholt*).

historic common law and equitable principles[18] unless clearly rendered inapplicable by express statutory language or changed circumstances.[19]

C. Application of the Doctrine of *In Pari Delicto* to Bar Plaintiffs' Claims Implied from the Anti-Fraud Provisions of the Securities Laws is Consistent with the Concepts Articulated in *Perma Life Mufflers, Inc. v. International Parts Corp.*

1. In *Perma Life*, This Court Held That the *In Pari Delicto* Defense Would Not Bar Statutory Antitrust Claims by a Plaintiff Whose Cause of Action Congress Had Elevated Above Common Law Impediments and Whose Fault Was Not Equal to That of the Defendant.

In 1968, this Court addressed the availability of the *in pari delicto* defense to a private treble damage action under the federal antitrust laws in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968). Plaintiffs in *Perma Life* were automobile exhaust parts dealers who challenged restrictions that defendant manufacturer in-

[18]This Court and the lower federal courts frequently have returned to the common law as a source of sound principles to guide decisions in cases involving federally-granted rights. *See Briscoe v. LaHue*, 460 U.S. 325, 330-34 (1983) (witness immunity); *Chiarella v. United States*, 445 U.S. 222, 227-29 (1980) (duty of disclosure); *New York Times v. Sullivan*, 376 U.S. 254, 280 (1964) (actual malice).

[19]Even in cases where statutes have explicitly overridden common law principles, this Court has held that such statutes in derogation of common law are to be construed narrowly. *Norfolk Redevelopment and Housing Authority v. C & P Telephone*, 52 U.S.L.W. 4007 (1983); *see Fairfax's Devisee v. Hunter's Lessee*, 11 U.S. (7 Cranch) 603, 623 (1813). Here, of course, plaintiffs have never been able to point to any provision in the securities laws that overrides the common law defense of *in pari delicto* in tippee versus tipper lawsuits.

cluded in its franchise agreements with them. Plaintiffs claimed that defendants had established an illegal price-fixing conspiracy and unlawful tying arrangements.

This Court, in an opinion by Justice Black, concluded that the manufacturer could not assert the *in pari delicto* defense against its dealers.[20] The Court decided that the defense was inapplicable for two reasons, only one of which commanded unequivocal support from a majority of the Court, and neither of which is applicable here. The keystone of Justice Black's opinion for the Court was a dual finding (1) that the Clayton Act's express treble damage "private attorney general" provision evinced Congress' belief that enforcement of national antitrust policy was paramount to otherwise available common law defenses and required maintenance of the private action; and (2) that the plaintiffs there could not be said to be equally responsible for the illegal provisions of the dealership agreement that they challenged.

The first underpinning for Justice Black's opinion for the Court, which was absent from the other four opinions, was that the federal antitrust statutes did not reveal any congressional intent to make the common law *in pari delicto* doctrine a defense to treble damage actions. Citing previous antitrust decisions in which the court had refused to invoke common law defenses, the Court concluded that it would not apply the *in pari delicto* defense to bar claims brought pursuant to the express treble damage private

[20]The case produced five opinions. Chief Justice Warren and Justices Brennan and Douglas concurred in Justice Black's opinion. Justice White wrote an opinion concurring in the opinion of the Court, and Justices Fortas and Marshall each wrote separate opinions concurring in the result. Justice Harlan, joined by Justice Stewart, wrote a fifth opinion concurring in part and dissenting in part.

action provision in the antitrust laws because those laws "encourag[e a plaintiff's] suit to further the overriding public policy in favor of competition." 392 U.S. at 139.[21]

Justice Black's second conclusion was that the facts of the case did not warrant application of the doctrine because plaintiffs' acts fell far short of equal culpability. *Id.* at 139-40.[22] He reserved the question whether "truly complete involvement and participation in a monopolistic scheme would ever be a basis . . . for barring a plaintiff's cause of action." *Id.* at 140.

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[21]It might be argued that in considering whether the defense would frustrate an antitrust statute specifically designed to protect the plaintiffs from the conduct complained of, the Court was reasoning along the lines of an historic common law exception to the *in pari delicto* doctrine.

Courts at common law would not apply the *in pari delicto* defense to bar claims of a plaintiff for whose protection the law that made plaintiff's action illegal was enacted. *See, e.g., A. C. Frost & Co. v. Coeur d'Alene Mines Corp.*, 312 U.S. 38 (1941) (plaintiff entitled to prevail on common count for money had and received based upon breach of an option agreement to sell stock which was unregistered); *Smith v. Bromley*, 99 Eng. Rep. 441 (1760) (Lord Mansfield) (plaintiff allowed to recover payment made to induce defendant creditor to sign bankruptcy certificate because law violated was designed to protect plaintiff from oppression, extortion, or deceit).

[22]This Court clearly felt that plaintiffs' illegal acts had been coerced. *See, e.g., id.* at 139 ("[T]heir participation was not voluntary in any meaningful sense. They sought the franchises enthusiastically but they did not actively seek each and every clause of the agreement. Rather, many of the clauses were quite clearly detrimental to their interests, and they alleged that they had continually objected to them. Petitioners apparently accepted many of these restraints solely because their acquiescence was necessary to obtain an otherwise attractive business opportunity.").

An exception to the *in pari delicto* defense for "economic coercion" can be traced to this Court's early decisions considering the defense. This Court noted in *Sample v. Barnes*, 55 U.S. (14 How.) 70 (1852):

> [I]f one party acts under oppression, imposition, hardship, undue influence, or great inequality of age or condition,

Chief Justice Warren and Justices Brennan, Douglas and White joined Justice Black's opinion; but Justice White wrote a separate concurrence to emphasize his view that the defense should apply where plaintiff and defendant are substantially equally responsible for the violation (*id.* at 146) (White, J., concurring), and four additional justices shared that view, in three separate opinions. Justice White wrote:

> Generally speaking, however, I would deny recovery where plaintiff and defendant bear substantially equal responsibility for injury resulting to one of them but permit recovery in favor of the one less responsible where one is more responsible than the other.[23]

> although he may be in delicto, he is not in pari delicto, and may have relief in equity. 1 Story, Eq. Jur. sec. 300; *Osborne v. Williams*, 18 Ves. 379; *Phalen v. Clark*, 19 Conn. 421; *Pinckston v. Brown*, 3 Jones (N.C.) Eq. 494; *Freelove v. Cole*, 41 Barb. 318; *Goodenough v. Spencer*, 15 Abb. Pr. N.S. 248; 46 How. Pr. 347; 2 Thomp. & C. 508.

55 U.S. at 71. The coercion theory became an important part of antitrust case law in *Ring v. Spina*, 148 F.2d 647 (2d Cir. 1945), where the court refused to apply the *in pari delicto* defense against a plaintiff drama producer who had been economically coerced into signing the Dramatist Guild's Minimum Basic Agreement, which fixes terms under which Guild members license or sell their works. The court explained:

> [P]laintiff is precisely the type of individual whom the Sherman Act seeks to protect from combinations fashioned by others and offered to such individual as the only feasible method by which he may do business. Considerations of public policy demand court intervention in behalf of such a person, even if technically he could be considered in pari delicto . . . . Any other conclusion would mean that for many, perhaps most victims of restraint of trade, private remedies under the Sherman Act would be illusory if not quite non-existent.

Ring v. Spina, 148 F.2d 647, 653.

[23]The analysis was presented in terms of relative causation of injury, but the concept of equality of fault appeared to be the critical factor, as in other applications of the *in pari delicto* defense.

Id. (White, J., concurring).

Concurring in the result only, Justice Fortas wrote:

> If the fault of the parties is reasonably within the same scale — if the *"delictum"* is approximately *"par"* — then the doctrine should bar recovery.

Id. at 147 (Fortas, J., concurring in result).

Justice Marshall wrote separately to endorse a similar view:

> I believe that a limited application of the basic principle behind the doctrine of *in pari delicto* is both proper and desirable in the antitrust field. As the Court notes, *ante,* at 138, the literal meaning of *in pari delicto* is of equal fault. I would hold that where a defendant in a private antitrust suit can show that the plaintiff actively participated in the formation and implementation of an illegal scheme, and is substantially equally at fault, the plaintiff should be barred from imposing liability on the defendant.

Id. at 149 (Marshall, J., concurring in result).

Justice Marshall went on to state:

> . . . I cannot agree that the public interest requires that a plaintiff who has actively brought about illegal restraints on competition for his own benefit be permitted to demand redress — in the form of treble damages — from a partner who is no more responsible for the existence of the illegality than the plaintiff.

Id. at 151.

Finally, Justice Harlan, concurring in part and dissenting in part in an opinion joined by Justice Stewart, stated as follows:

> I would remand this case to determine whether any agreement alleged to be in restraint of trade was one for which the plaintiffs were substantially as much responsible, and as much legally liable, as the defendants.

Id. at 156 (Harlan, J., concurring in part and dissenting in part).

A majority of five justices of this Court thus agreed that a plaintiff's culpability should serve as a defense to even a statutory private antitrust action in circumstances where the plaintiff's conduct was substantially equal in culpability to the defendant's. This relative equality of fault, which is an essential predicate to availability of the *in pari delicto* defense, and which this Court determined was absent in *Perma Life,* is present here.

2. No Intent of Congress to Bar Common Law Defenses Such as *In Pari Delicto* May Be Divined from the Securities Laws Upon Which Plaintiffs Rely.

There are crucial distinctions between the antitrust statutes considered in the *Perma Life* decision and the securities laws upon which plaintiffs rely here. Congress in the antitrust laws explicitly provided for private actions with treble damage penalties to foster private enforcement of competition laws. Clayton Act § 4, 15 U.S.C. § 15 (West 1973 & Supp. 1984), formerly Sherman Act § 7. Such private actions did not exist at common law to redress unfair competition. *See* 1 E. Kintner, Legislative History of Antitrust Statutes 34 (1983 ed.); 1 J. von Kalinowski, Antitrust Laws and Trade Regulation § 1.02[4] at 35-36 (1984 ed.) ("At common law, contracts in restraint of trade and combinations to monopolize were not unlawful in the sense of being criminal, nor did their existence give rise to a civil action.")[24]

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[24]Thus, while a contract that unreasonably restrained trade was void and unenforceable at common law, such a contract did not

The treble damage and attorneys' fee provisions in the antitrust laws obviously reflect Congress' desire to go beyond the common law in the antitrust statute in order to provide substantial encouragement to private enforcement and to help deter anticompetitive conduct.[25] In the securities laws, by contrast, the Congress failed to provide an express private right of action for securities fraud under Section 10 of the Securities Exchange Act or Section 17 of the Securities Act, leaving a remedy for violation of those sections either non-existent or to be implied from language couched in terms similar to the elements of common law fraud.

Moreover, in the Insider Trading Sanctions Act of 1984 (the "Act"), the Congress only recently expressly provided treble penalty provisions, but only in enforcement proceedings by the SEC, and only against any purchaser or seller who trades on material non-public information in violation of the Securities Exchange Act. Insider Trading Sanctions Act, § 2, 1984 U.S. Code Cong. & Ad. News (98 Stat.) 1264 (to be codified at 15 U.S.C. § 78u(d)(2)) (Brief App. at A-2-A-6). Congress clearly did not see any national policy

afford an injured party an opportunity to sue for damages or injunctive relief. *See United States v. Addyston Pipe & Steel Co.*, 85 F. 271, 279 (6th Cir. 1898), *aff'd*, 175 U.S. 211 (1899) (Sherman Act created private right of action for damages and/or injunctive relief that was previously unavailable); *State v. Duluth Board of Trade*, 107 Minn. 506, 121 N.W. 395, 404 (1909) (contract in restraint of trade simply unenforceable); *see also Mogul Steamship Co., Ltd. v. Mcgregor, Gow & Co.*, 1892 A.C. 25 (no damages action for restraint of trade at common law).

[25]The legislative history confirms that this was Congress' intent. *See* 21 Cong. Rec. 2569, 3147, *reprinted in* 1 E. Kintner, The Legislature History of the Federal Antitrust Laws and Related Statutes ("Legislative History") 177, 283 (1978) (remarks of Senator Sherman, Senator Reagan); *id.* at 34 ("The original section 7 of the [Sherman Antitrust] Act (now found in section 4 of the Clayton Act, as modified) was of primary importance in that it created a private right of action not present under common law whereby any person

requiring special assistance from private litigants in enforcing bans on insider trading.[26]

The implied right of action under Rule 10b-5 thus is a product of implication from a statute utilizing language consistent with intentional fraud rather than negligence or strict liability. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197-201 (1976). This Court has stated that it acknowledged that right of action for damages under Section 10(b) of the Securities Exchange Act because of nearly four decades of decisions implying this remedy (*Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983)), which began with the application of common law principles to a securities law fraud violation in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D.Pa. 1946).[27] The court held in *Kardon* that the right to recover damages arising from fraudulent

"injured in his business or property" by reason of any violation of the Act is entitled to sue for treble the damages sustained including the cost of suit and a reasonable attorney's fee.").

The remedial section of the bill was modified during the consideration of the various versions of the Sherman Act. The Senate Judiciary Committee increased the recoverable damages from double to treble. *Compare* S. 1, § 2, as printed March 26, 1890, *reprinted in* Legislative History at 257-58 *with* S. 1, § 7, as reported April 2, 1890, *reprinted in* Legislative History at 277.

[26]The legislative history of the Insider Trading Sanctions Act reveals that the SEC never suggested and the Congress never even considered creating private actions as part of the Act or making the treble damage penalties available in any private actions that may already exist. Instead, the focus of the legislative proceedings was on the SEC's need for an additional remedy to employ in connection with the *existing* SEC enforcement provisions, in order to create a greater disincentive for those who actually *trade* on insider information. *See, e.g., Hearing on H.R. 559 Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs*, 98th Cong., 2d Sess. 14 (April 3, 1984) (Statement of The Honorable John S. R. Shad, Chairman, SEC).

[27]*See also Merrill Lynch, Pierce, Fenner & Smith v. Curran, Inc.*, 456 U.S. 353, 379 (1982) (affirming existence of an implied action

conduct described in Section 10(b) and Rule 10b-5 "is so fundamental and so deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very clearly and plainly." *Id.* at 514. A private right of action under Section 17(a) of the Securities Act, as alleged here, must be implied by the same route, if such a right exists at all.[28]

If, as noted above, this Court has acquiesced in the recognition of certain implied private rights of action in part because they were long recognized by lower courts and not disturbed by the Congress, then equally this Court should not disturb the long-time recognition of *in pari delic-*

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under the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.*, in part because of Congressional acquiescence in the courts implication of the right); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 (1975) (refusing to extend 10b-5 actions beyond actual purchasers or sellers, in part because of Congress' failure to reject the courts' limitation to that effect).

[28]A conflict appears to exist among the circuits that have decided this question, but a comparison of those cases which allow for a private right of action under § 17(a) with those cases which do not reveals that since the decisions of this Court in *Touche Ross & Co. v. Redington, Trustee*, 442 U.S. 560 (1979), and *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979), most courts have been disinclined to find an implied private right of action. *See e.g.*, the following cases determining that no private right of action exists under Section 17(a): *Keys v. Wolfe*, 709 F.2d 413, 416 (5th Cir. 1983); *Simpson v. Southeastern Investment Trust*, 697 F.2d 1257, 1258 (5th Cir. 1983); *Shull v. Dain, Kalman & Quail, Inc.*, 561 F.2d 152, 155, 159 (8th Cir. 1977). *Compare, e.g.*, the following decisions which have allowed a private right of action under § 17(a): *Newman v. Prior*, 518 F.2d 97, 99 (4th Cir. 1975); *Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808, 815 (9th Cir. 1981).

This Court does not need to decide the availability of a private action under Section 17 now, because regardless of the decision, there is no reason to consider the *in pari delicto* defense differently depending on whether the claim is a Section 17(a) or a Section 10(b) claim. Indeed, because a Section 17(a) private right of

to in securities fraud cases. It is appropriate to assume both Congress' awareness of the well-established existence of common law defenses when it enacted the Securities Act in 1933 and the Securities Exchange Act in 1934 and its awareness of the courts' application of common law defenses to securities law fraud claims during the intervening years prior to the passage of the Insider Trading Sanctions Act of 1984. *See Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 379 (1982), (quoting *Cannon v. University of Chicago*, 441 U.S. 677, 696-97 (1979) ("It is always appropriate to assume that our elected representatives, like other citizens, know the law. . . .")).

Indeed, Congress even included savings clauses in the Securities Act and Securities Exchange Act to leave no room for doubt as to its intentions. Those savings clauses state that "[t]he rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity." Section 16 of the Securities Act; Section 28 of the Securities Exchange Act. In contrast, neither the Sherman Act nor the Clayton Act contains a "savings clause" preserving common law rights and remedies. Sherman Antitrust Act, 26 Stat. 209 (1890), *codified at* 15 U.S.C.A. § 1 *et seq.* (West 1973 & Supp. 1984); Clayton Act, 38 Stat. 731, 15 U.S.C. § 12 *et seq.* (West 1973 & Supp. 1984).

In its amicus brief to the court of appeals below, the SEC argued from its prosecutorial perspective that elimination of the common law *in pari delicto* defense where a broker is a defendant would aid in the enforcement of the securities

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action, if one were held to exist, would have to be judicially implied just as a Rule 10b-5 claim has been, it necessarily would be equally subject to common law defenses. A number of district courts, including the district court below, have concluded that the defense applies to Section 17(a) claims. *See In re Haven Industries, Inc.*, 462 F. Supp. 172, 181 (S.D.N.Y. 1978); *Jackson v. Oppenheim*, 411 F. Supp. 659, 665 (S.D.N.Y. 1974).

laws. The Commission noted that it "strongly agrees that illegal tippee trading poses a serious threat to the investing public," Brief of SEC at 15, and advised the court that it was therefore supporting legislation, now enacted as the Insider Trading Sanctions Act, to reduce such activity. Yet neither the language nor the two-year legislative history of that Act[29] supports the supposed need for private civil tippee versus tipper actions as an essential law enforcement tool against insider trading.

Furthermore, the SEC's utilitarian arguments regarding deterrence do not withstand analysis in light of logic and relevant provisions of the securities laws, as the Third, Fourth and Fifth Circuit Courts of Appeals have concluded and as most district courts have agreed. *See, e.g., Tarasi v. Pittsburgh National Bank,* 555 F.2d 1152 (3d Cir.), *cert. denied,* 434 U.S. 965 (1977); *Malamphy v. Real-Tex Enterprises, Inc.,* 527 F.2d 978 (4th Cir. 1975); *Kuehnert v. Texstar Corp.,* 412 F.2d 700 (5th Cir. 1969); *Grumet v. Shearson/American Express, Inc.,* 564 F.Supp. 336 (D.N.J. 1983); *Kirkland v. E.F. Hutton and Co., Inc.,* 564 F. Supp. 427 (E.D. Mich. 1983); *In re Haven Industries, Inc.,* 462 F. Supp. 172 (S.D.N.Y. 1978); *Summerlin v. Blyth, Eastman Dillon & Co.,* [1982-83 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197 (N.D. Ga. 1983).

Rejection of the *in pari delicto* defense in the name of protecting the public interest under the securities laws would disserve the very policies the securities laws purport to guard. The Third Circuit Court of Appeals in *Tarasi v. Pittsburgh National Bank, supra,* 555 F.2d 1152, assessed the policy question as follows:

> [P]ermitting *in pari delicto* could have a more telling effect on "tippee" conduct. As Judge Aldrich noted in *Kuehnert,* the danger of eliminating *in pari delicto* is that such a stance would give "tippees" almost no incentive to forebear from using inside information. This is so since if the suggested purchase proved unprofitable, the "tippee" might have recourse against his "tipper" on account of the inaccurate leak. The threat of application of *in pari delicto* would eliminate the warranty of the accuracy of the tip that might otherwise exist.
>
> Moreover, . . . as *Kuehnert* pointed out, substantial deterrents to "tippers" are provided by the possibility of SEC and criminal actions and private suits by non-"tippee" purchasers and sellers who have been adversely affected by the dissemination of inside information.

Id. at 1163-64 (footnotes omitted).

Unlike the SEC's and plaintiffs' arguments regarding the deterrent effect of eliminating the *in pari delicto* defense, the deterrents to tippers referenced in *Tarasi* are not hypothetical but instead are statutory. A securities broker-dealer is a highly visible[30] and vulnerable member of a

[29]See footnote 26, *supra.*

[30]The court in *In re Haven Industries, Inc.,* 462 F. Supp. 172 (S.D.N.Y. 1978) noted this visibility:

> Although the "tippee" is then potentially liable to his vendors or vendees for violating Rule 10b-5, his remoteness from the insider group may, as a practical matter, make it difficult to discover him and thus effectively insulate him from liability. By contrast, substantial deterrents to "tippers" would remain in the form of SEC and criminal actions as well as private suits by non-"tippee" purchasers and sellers who have been adversely affected by the selective disclosure of inside information . . . .
>
> . . . . Elimination of the defense would remove the most effective disincentive against the "tippee's" use of inside information. Because of the tippee's relatively low visibility, the threat of discovery and potential liability is slight. By contrast, "tippers" are usually highly visible officers, directors or brokerage firms, subject to extensive statutory disclosure requirements, SEC enforcement actions and private suits by non-"tippee" purchasers or sellers.

462 F. Supp. at 180.

regulated industry. Thus, a broker-dealer who disseminates material inside information or who, as claimed by plaintiffs, disseminates false information in violation of the securities laws is subject to various enforcement remedies of the Securities and Exchange Commission.[31] Furthermore, a broker-dealer in such circumstances also is subject to discipline, suspension or expulsion from the stock exchanges or other self-regulatory entities through which it does business.[32]

The Fifth Circuit Court of Appeals recognized that insider trading will be encouraged if the *in pari delicto* defense is eliminated, in *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969). The court reasoned that the most effective way to deter tippees from trading on what they believe to be inside information is to remove the tippee's guarantee

[31]*See, e.g.*, 15 U.S.C. § 77t(b) (Commission may bring action for injunction or criminal prosecution for violations of Securities Act); 15 U.S.C. § 78o(b)(4)-(6) (Commission may bring administrative proceedings against broker-dealer seeking censure, limitations on activities and suspension or revocation of registration of broker-dealer or person associated with broker-dealer); 15 U.S.C. § 78u(a) (Commission may investigate and issue report of such investigations whenever person has violated, is violating or is about to violate Securities Exchange Act, its rules or regulations thereunder, rules of national securities exchange or registered securities association of which such person is member, rules of registered clearing agency in which such person is participant, or rules of Municipal Securities Rulemaking Board); 15 U.S.C. § 78u(d) (Commission may bring action to enjoin violations of Securities Exchange Act, its rules or regulations thereunder, rules of national securities exchange or registered securities association of which such person is member, or rules of registered clearing agency in which such person is participant).

[32]*See, e.g.*, Article XIV of the Constitution of the New York Stock Exchange and the rules promulgated thereunder; Article V of the Constitution of the American Stock Exchange and the rules promulgated thereunder; Rule IV of the Rules of Fair Practice of the National Association of Securities Dealers. *See also* 15 U.S.C. § 78o-3(g); 15 U.S.C. § 78s(d)-(f).

and to allocate the risk of financial loss upon the tippee-trader in the event of a false tip:

> If a tippee can sue he has, in effect, an enforceable warranty that secret information is true. It is then that he will have free rein. If what he is told is false, he can recover against his informer. If it is true, he will, of course, be liable to his vendors or vendees, but here he may well be protected by the difficulties of discovery. It may be relatively easy to trace insiders; tippees are another matter.
>
> The growth of 10b-5 actions has not thus far been handicapped observably by the absence of suits by tippees against insiders. Nor do we believe that *in pari delicto* and unclean hands have limited the effectiveness of the proxy regulations. Therefore, in view of the substantial deterrent pressures already felt by the corporate insider, *SEC v. Texas Gulf Sulphur Co.*, [401 F.2d 833 (2nd Cir. 1968), *cert. denied sub nom, Coates v. SEC,* 394 U.S. 976 (1969)], we think it important that tippees, who present the same threat to the investing public as do insiders themselves, should be offered appropriate discouragement. We conclude that the better choice is to leave upon persons believing themselves tippees the restraint arising from the fear of irretrievable loss should they act upon a tip which proves to have been untrue. Hence the loss must lie where it falls.

412 F.2d at 705 (footnotes omitted).[33]

[33]As was recognized in *Wohl v. Blair & Co.*, 50 F.R.D. 89 (S.D.N.Y. 1970), the more effective technique for halting future trading on inside information is to allocate the risk of financial loss on the tippee-trader, and make him aware that his investment could well be lost:

> [I]t may well be that much of the excessive and inflationary speculation in securities is attributable to customers seeking

Justices White and Marshall voiced these same concerns in the antitrust context in their concurring opinions in *Perma Life*:

> In the third case, [of a conspiracy to set prices among D & E] where D and E are competitors, if D simply proves the agreement and the resulting loss, should he recover from E, absent some believable showing that E was the more responsible for the illegal scheme? No doubt E was a substantial factor in the combination and hence in the injury; a judgment for damages might deter him and others from violating the law. But D is equally responsible for his own damages. To permit him a recovery may be a counterdeterrent.

392 U.S. at 146 (White, J., concurring).

> The possible added deterrence to violations of the antitrust laws that would be produced by the Court's holding [limiting the defense in antitrust actions] may well be equaled, if not surpassed, by the new incentive it will create to commit such violations, for a potential violator will have less to lose if he can attempt to recover his losses from his partner should the scheme not work out to his benefit.

Id. at 151 (Marshall, J., concurring in result).

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information which they are not entitled to unless and until it is freely available to all. One possible solution may be the adoption of a form of "*caveat tippee*" policy. If such customers learn that they accept "inside information" at their own risk, many may decide that it is better to reject proffers of such information and to play the game according to the laws and SEC rules enacted for their protection than to risk loss of their hard-earned capital.

50 F.R.D. at 93.

This identical rationale echoes through decisions of other courts faced with the question of who should bear the risk of loss in tippee versus tipper civil litigation.[34] *See, e.g., In re Haven Industries, Inc.*, 462 F. Supp. 172, 179-80 (S.D.N.Y. 1978) ("[E]limination of the *in pari delicto* defense eliminates any incentive for the 'tippee' to refrain from using inside information .... [because] [i]f what has been disclosed is false, he can recover against the tipper; if the inside information is true, he is virtually certain to make an illegal profit"); *Wolfson v. Baker*, 623 F.2d 1074, 1082 (5th Cir. 1980) ("Any deterrent effect of threatened liability on the broker may well be more than offset by the inducement to violations inherent in the prospect of a free ride for the customer who . . . is placed in the enviable position of 'heads-I-win tails-you-lose' " (quoting *Pearlstein v. Scudder & German*, 429 F.2d 1136, 1148 (2d Cir. 1970) (Friendly, J., dissenting), *cert. denied*, 401 U.S. 1013 (1971)), *cert. denied*, 450 U.S. 966 (1981).

Thus, as these courts have recognized, the tippee could trade with impunity if the defense were unavailable. If the information were intentionally false, he could sue his broker or officer tipper to recover his losses or his expected profits. If the information proved true, he could reap a bonanza. A decision upholding the result reached by the

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[34]The Ninth Circuit Court of Appeals rejected this critique of the elimination of the defense, concluding that a purported tippee does not have a "warranty of accuracy" because he could not sue his tipper if his tipper did not have an "intent to deceive, manipulate or defraud." (730 F.2d at 1324 n. 3, quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976)). That analysis cannot justify elimination of the defense, however, because it overlooks the effect of that elimination: permitting resort to the courts by those who intentionally violated the securities laws in transactions with sellers of securities who were entirely blameless.

Ninth Circuit Court of Appeals accordingly would foster the very insider trading that Congress has just attempted to reduce.

Plaintiffs' claims under Sections 10 and 17 are, after all, comparable to fraud claims arising under the laws of any common law jurisdiction prohibiting willful fraudulent conduct. This historic teaching of these jurisdictions that barring relief to wrongdoers deters fraud does not lose its force because securities fraud laws are at issue.

Yet even if plaintiffs' and the SEC's position below were correct, the defense should still apply. That a particular result will advance the SEC's prosecutorial goals, however laudatory they may be, is simply insufficient to mandate the result the SEC seeks when the statutory and decisional law do not support it.[35] This conclusion takes on even greater

[35]*See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), where this Court refused the SEC's request that it extend Section 10(b) of the Exchange Act and Rule 10b-5 beyond actual purchasers and sellers despite the literal language of the section and rule. Justice Powell, joined by Justices Stewart and Marshall, wrote:

> The courts already have inferred a private cause of action that was not authorized by the legislation. In doing this, however, it was unnecessary to rewrite the precise language of § 10(b) and Rule 10b-5. This is exactly what respondent – joined, surprisingly, by the SEC – sought in this case. If such a far-reaching change is to be made, with unpredictable consequences for the process of raising capital so necessary to our economic well-being, it is a matter for the Congress, not the courts.

Id. at 759-60 (Powell, J., concurring).

Absent a legislative action to the contrary, which has not occurred here, this Court repeatedly has refused to accede to such requests that it advance prosecutorial aims. Thus, this Court in *Chiarella v. United States*, 445 U.S. 222 (1980), and *Dirks v. SEC*, — U.S.—, 103 S.Ct. 3255 (1983), refused to find violations of securities laws in connection with insider trading in situations where the securities laws incorporating common law principles failed to create a duty applicable to the defendants. *Dirks, supra*, 103 S.Ct. at 3261, 3268; *Chiarella*, 445 U.S. at 227-28, 236-37.

force in light of the fact, established in Section II.A.2., that a principal purpose of the *in pari delicto* defense is to preserve and protect the integrity of the courts. Courts barring claims by tippees have so recognized.[36]

III

PLAINTIFFS' CONDUCT ADMITTED IN THEIR COMPLAINT IS MORE THAN SUFFICIENTLY WRONGFUL TO BAR THEIR CLAIMS FOR RELIEF.

The SEC in its amicus brief to the Ninth Circuit Court of Appeals conceded that the *in pari delicto* doctrine should bar a plaintiff tippee's claims when the parties are equally at fault. Brief of SEC at 6. Actually, the proper standard is *substantial* equality of fault because confessed, purposeful transgressors are not entitled to insist upon fine distinctions of blame. Plaintiffs admit that they intentionally and repeatedly traded on what they knew to be improperly obtained inside information, although they allege that some of that information later proved false or incomplete. As explained in full in Section I, above, plaintiffs' allegations establish their own violations of the securities fraud provisions under this Court's decisions in *Dirks v. SEC* and

[36]The affront to a court's integrity that would result from entertaining the damage claims of a tippee whose greedy trading did not yield the results he planned was recognized in *Tarasi v. Pittsburgh Nat'l Bank, supra*, where the Third Circuit Court of Appeals noted in affirming application of the defense:

> [W]e believe it not improper to take into consideration the factors that form the basis of *in pari delicto:* augmenting the integrity of the courts and preventing wrongdoers from profiting from their misdeeds.

555 F.2d at 1164. *See also James v. DuBreuil*, 500 F.2d 155, 160 (5th Cir. 1974) ("If plaintiff was duped in the process, it is not our role to serve as referee in an accounting between two coconspirators"); *Kirkland v. E. F. Hutton and Co., Inc.*, 564 F. Supp. 427, 436 (E.D. Mich. 1983) ("[T]he interest in preserving the integrity of the courts by denying recourse to those who are as blameworthy as those from whom they seek to recover, lead[s] me to conclude that the defense is applicable. . . .").

Chiarella v. United States. There is nothing in the securities laws which warrants a greater tenderness toward tippees who defraud the investing public than toward alleged tippers. Because the culpability and the immoral purpose of the tippee-plaintiffs and of the alleged tipper was at least substantially equal according to the allegations of the complaint, the "fault" of the parties under the securities laws therefore is also at least equal.

Yet the SEC's amicus brief below argues that even though the *in pari delicto* defense is applicable to securities fraud claims, it should almost never be allowed where the defendant is a broker-dealer. This suggestion ignores the language of the involved provisions, which each proscribe fraudulent conduct by "any person." The argument also disregards the high level of culpability of the trading tippee, and it fails entirely to recognize the dynamics of the harm to the market that trading on inside information causes.

The federal securities statutes and rule at issue here, Securities Act Section 17(a), Securities Exchange Act Section 10(b) and Rule 10b-5, govern the rights and duties of *all* investors, not just securities professionals, when they explicitly set one standard for all by proscribing fraudulent conduct by "any person."[37] These provisions do *not* limit their application only to conduct by brokers and corporate officers, nor do they impose any hierarchy of guilt or liabil-

[37]Indeed, the "any person" language was never varied at any time from the date of the introduction of the Securities Exchange Act in the Senate on April 17, 1934, S. 3420, 73d Cong., 2d Sess., through the introduction of a similar bill in the House on April 25, 1934, H.R. 9323, 73d Cong., 2d Sess., through the Conference Report to accompany H.R. 9323, Conf. Rep. 1838, 73d Cong., 2d Sess., May 31, 1934, *all reprinted in* 1 Federal Securities Laws Legislative History 1933-1982, at 650, 755, 1169, 1179 (1983). The same is true for the history of what ultimately became Section 17(a). *See* S. 875, 73d Cong, 1st Sess., introduced March 29, 1933; H.R. 5480, 73d Cong., 1st Sess., introduced May 3, 1933; Conference Report to accompany H.R. 5480, Conf. Rep. No. 152, 73d Cong., 1st Sess., May 20, 1933, *all reprinted in* 1 Federal Securities Laws Legislative History 1933-1982, *supra*, at 27, 99, 252.

ity. But if a hierarchy of culpability were to be created, the tippee, without whose trades no harm would occur, would be the more guilty party.

Counsel for petitioners have not uncovered any basis in the language or history of any provisions of the federal securities laws applicable to both brokers and traders that would impose a higher duty to the market on securities professionals by virtue of their professional status. To the contrary, in *Dirks v. SEC* this Court described as "novel" the suggestion that broker-dealers operate under a special duty to the general public by virtue of their status. 103 S. Ct. at 3255.

The dichotomy suggested by the SEC and drawn in the Ninth Circuit Court of Appeals' opinion is all the more inappropriate because it shields the very persons who are directly causing the damage to the market that the Congress enacted the Securities and Securities Exchange Acts to prevent. A broker's dissemination of false information about a company does not alter the price of that company's stock or otherwise harm its holders or sellers. But the tippee who trades in the stock, thinking he has an informational advantage over the innocent investor, directly causes an adverse impact on the market. This is precisely what the Congress sought to eliminate by the Securities Exchange Act, one purpose of which is "to assure that dealing in securities is fair and without undue preferences or advantages among investors." Conf. Rep. No. 229, 94th Cong., 1st Sess., May 19, 1975, *reprinted in* 3 Federal Securities Laws Legislative History 1933-1982, at 3041, 3128 (1983). Tippees thus harm the market as much as, if not more than, their tipper and corporate insider do.

Moreover, by definition a tippee who trades on what he believes to be inside information without disclosing it to the other party to his trade acts with scienter, just as does a tipper who knowingly disseminates false inside information.

The Third Circuit Court of Appeals addressed the concept of equal responsibility with insight in *Tarasi v. Pittsburgh National Bank, supra*, 555 F.2d at 1162:

> [T]his litigation contains an important element, absent in *Perma Life,* that, we believe, makes it an instance of joint participation in wrong-doing — specifically, voluntary illegal conduct on the part of the plaintiffs.
>
> *Perma Life* emphasized the fact that the participation by the plaintiffs in the unlawful agreement was passive, and perhaps coerced. . . .
>
> The fact that the plaintiffs in this case willingly committed illegal acts would seem to obviate these concerns to a substantial degree. . . . Moreover, it should be noted that the voluntary illegal activities of the plaintiffs present a serious threat to the investing public, which the securities laws seek to prevent. Finally, the voluntary acts of the plaintiffs may fairly be said to be a sine qua non of their losses; but for their purchases of Meridian securities, they would not have suffered any injury.

Id. at 1162 (footnote omitted).

Legally and factually, this substantially equal culpability and responsibility of plaintiffs renders the *in pari delicto* defense applicable to bar plaintiffs' claims.

CONCLUSION

This Court should reverse the judgment of the United States Court of Appeals for the Ninth Circuit and enter a judgment dismissing this action and holding that plaintiffs' implied securities fraud claims are barred by the *in pari delicto* defense, based on their admitted violations of the very statutes they seek to assert against defendant and petitioner BEHR. This result will confirm and promote the sound public policies of judicial integrity and deterrence underlying the defense.

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Brief Appendix A — Statutory Provisions Involved

Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a) (1982), states:

> (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b) (1982), states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1985), states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The Insider Trading Sanctions Act, 1984 U.S. Code Cong. & Ad. News (98 Stat.) 1264, to be codified at Section 21(d) of the Securities Exchange Act, 15 U.S.C. § 78u(d), states:

> SECTION 1. This Act may be cited as the "Insider Trading Sanctions Act of 1984."
>
> SEC. 2. Section 21 of the Securities Exchange Act of 1934 is amended by redesignating subsection (d) as subsection (d)(1), and adding at the end thereof the following new paragraph:
>
> "2(A) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material non-public information in a transaction (i) on or through the facilities of a national securities

> exchange or from or through a broker or dealer, and (ii) which is not part of a public offering by an issuer of securities other than standardized options, *the Commission may bring an action in a United States district court to seek*, and the court shall have jurisdiction to impose, *a civil penalty* to be paid by such person, or any person aiding and abetting the violation of such person. The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States. If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission shall refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court. The actions authorized by this paragraph may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring. For purposes of Section 27 of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this title. The Commission, by rule or regulation, may exempt from the provisions of this paragraph any class of persons or transactions.
>
> "(B) No person shall be subject to a sanction under subparagraph (A) of this paragraph solely because that person aided and abetted a transaction covered by such sub-paragraph in a manner other than by communicating material non-public information. Section 20(a) of this title shall not apply to an action brought under this paragraph. No person shall be liable under this paragraph solely by reason of em-

ploying another person who is liable under this paragraph.

"(C) For purposes of this paragraph profit gained or loss avoided is the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the non-public information.

"(D) No action may be brought under this paragraph more than five years after the date of the purchase or sale. This paragraph shall not be construed to bar or limit in any manner any action by the Commission or the Attorney General under any other provision of this title, nor shall it bar or limit in any manner any action to recover penalties, or to seek any other order regarding penalties, imposed in an action commenced within five years of such transaction."

SEC. 3. Section 32 of the Securities Exchange Act of 1934 is amended by striking "$10,000" from subsection (a) and inserting in lieu thereof "$100,000".

SEC. 4. Section 15(c)(4) of the Securities Exchange Act of 1934 is amended to read as follows:

"(4) If the Commisions finds, after notice and opportunity for a hearing, that any person subject to the provisions of section 12, 13, 14, or subsection (d) of section 15 of this title or any rule or regulation thereunder has failed to comply with any such provision, rule, or regulation in any material respect, the Commission may publish its findings and issue an order requiring such person, and any person who was a cause of the failure to comply due to an act or omission the person knew or should have known

would contribute to the failure to comply, to comply, or to take steps to effect compliance, with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify in such order.".

SEC. 5. Section 20 of the Securities Exchange Act of 1934 is amended by adding at the end thereof the following:

"(d) Wherever communicating, or purchasing or selling a security while in possession of, material non-public information would violate, or result in liability to any purchaser or seller of the security under any provision of this title, or any rule or regulation thereunder, such conduct in connection with a purchase or sale of a put, call, straddle, option, or privilege with respect to such security or with respect to a group or index of securities including such security, shall also violate and result in comparable liability to any purchaser or seller of that security under such provision, rule, or regulation.".

SEC. 6. (a) Section(a)(39) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(39) is amended —

(1) by inserting before the semicolon at the end of subparagraph (A) the following: ", contract market designated pursuant to section 5 of the Commodity Exchange Act (7 U.S.C. 7), or futures association registered under section 17 of such Act (7 U.S.C. 21), or has been and is denied trading privileges on any such contract market";

(2) by inserting before the semicolon at the end of subparagraph (B) the following: ", or is subject to an order of the Commodity Futures Trading Commission denying, suspending, or revoking his regis-

tration under the Commodity Exchange Act (7 U.S.C. 1 et seq.)"; and

(3) by inserting after "municipal securities dealer," in subparagraph (C) the following: "or while associated with an entity or person required to be registered under the Commodity Exchange Act,".

(b) Section 15(b)(4) of such Act (15 U.S.C. 78o(b)(4) is amended —

(1) by striking out "or fiduciary" in subparagraph (1)(ii) and inserting in lieu thereof "fiduciary, or any entity or person required to be registered under the Commodity Exchange Act (7 U.S.C. 1 et seq.)"; and

(2) in subparagraph (C) —

(A) by inserting "entity or person required to be registered under the Commodity Exchange Act," before "or municipal securities dealer"; and

(B) by inserting "entity or person required to be registered under such Act," before "or insurance company"; and

(3) by inserting "the Commodity Exchange Act," after "Investment Company Act of 1940," each place it appears in subparagraphs (D) and (E).

SEC. 7. The amendments made by this Act shall become effective immediately upon enactment of this Act.

(Emphasis added).

No. 84-679

In the Supreme Court of the United States

OCTOBER TERM, 1984

Supreme Court, U.S.
FILED
MAR 27 1985
ALEXANDER L. STEVAS,
CLERK

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED,
PETITIONER

v.

CARL F. BERNER, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE SUPPORTING RESPONDENTS

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QUESTION PRESENTED

Whether an employee of a brokerage firm who induces investors to purchase securities by deliberately misrepresenting that he is communicating material nonpublic information about the issuer should be permitted to avoid liability to those investors in a private damages action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder on the ground that the defrauded investors are *in pari delicto* with him because they purchased securities on the false premise that they were tippees.

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In the Supreme Court of the United States

OCTOBER TERM, 1984

No. 84-679

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED,
PETITIONER

v.

CARL F. BERNER, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE SUPPORTING RESPONDENTS

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission is principally responsible for ensuring that securities brokerage firms and their employees comply with the federal securities laws. Private damages actions brought by investors under Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and Rule 10b-5 thereunder (17 C.F.R. 240.10b-5) serve as a "necessary supplement" to the efforts of the Commission to protect investors from fraudulent practices by securities professionals. See *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 730 (1975); *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964) ("As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the [securities laws].").

The Commission is concerned that the unduly broad application of the common law *in pari delicto* defense urged by petitioner will encourage securities professionals to engage in dishonest practices. In the Commission's view, it is important to vindicate the holding of the court of appeals that securities professionals may not use the *in pari delicto* defense to immunize themselves from private damages actions by the victims of their manipulative or fraudulent schemes merely because, as part of those schemes, they fraudulently induce investors to believe that they are trading on inside information.

STATEMENT

1. Petitioner Bateman Eichler, Hill Richards, Inc. is a securities brokerage firm. Respondents are investors who filed this action in the United States District Court for the Northern District of California, alleging that they suffered substantial losses by trading in securities as a result of a manipulative scheme engaged in by petitioner's employee Charles Lazzaro and Leslie Neadeau, president of T.O.N.M. Oil & Gas Exploration Corporation (TONM) (J.A. 5-27).[1] Respondents allege, inter alia, that this scheme violated Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and Rule 10b-5 promulgated thereunder (17 C.F.R. 240.-10b-5). Respondents claim that petitioner is liable for Lazzaro's fraudulent conduct as a "controlling person" with respect to Lazzaro under Section 20(a) of the Act (15 U.S.C. 78t(a)). J.A. 7, 14-17.

As set forth in respondents' complaint,[2] Lazzaro and Neadeau conspired to manipulate the price of TONM

[1] Although Lazzaro, Neadeau, and TONM are also respondents in this Court (Sup. Ct. R. 19.6), we shall for convenience use "respondents" to refer to the plaintiffs, who are defending the court of appeals' judgment in this Court.

[2] Because the district court dismissed the action pursuant to Fed. R. Civ. P. 12(b)(6), we construe the complaint in respondents' favor and assume the truth of their allegations.

stock by disseminating to investors false information about the company on the pretext that it was accurate inside information (J.A. 7-17). Lazzaro induced respondents to purchase substantial quantities of TONM stock by falsely representing to them that he had learned from TONM's president or vice-president that TONM had acquired the rights to a large gold discovery in Surinam and that the company was arranging to mine the gold (J.A. 10-12). Lazzaro told respondents that the discovery and mining preparations were not publicly known and that the price of TONM's stock would rise dramatically upon publication of the information (J.A. 11). The price of TONM stock increased from approximately $3 to $7 per share as a result of Lazzaro's activities, and then fell to less that $1 per share as the scheme came to an end (J.A. 13-14). Respondents suffered trading losses when the shares of TONM stock that they had acquired on Lazzaro's advice declined in value (J.A. 14).

Respondents admitted in their complaint that they purchased TONM stock "on the premise" that they had become "privy to certain information not otherwise available to the general public" (J.A. 10). Certain respondents also contacted Neadeau directly to confirm Lazzaro's information (J.A. 12). Neadeau refused to confirm or deny the story, but he did state that Lazzaro was "very trustworthy and a good man" (*ibid.*).

2. The district court dismissed the complaint for failure to state a claim (Pet. App. C1-C4). The district court ruled that respondents' Section 10(b) and Rule 10b-5 action was barred because they were *in pari delicto* with the defendants (Pet. App. C2-C3). The court stated that "trading on insider information is itself a violation of rule 10b-5" and that respondents had admitted in their complaint "that they acted on insider information (albeit false information) and therefore were tippees" (*id.* at C2). The district court refused to assess the relative fault of the parties on the ground that "both plaintiffs and defendants violated the particular statutory provision under which recovery is sought" (*ibid.*).

3. The court of appeals reversed (Pet. App. A1-A11). That court assumed that respondents had violated Rule 10b-5 by trading on what they believed to be inside information (Pet. App. A11). However, relying (*id.* at A3-A6) on the common law and on *Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134 (1968), the court of appeals concluded that the *in pari delicto* defense should be available in private securities actions only where "the investor is equally responsible [with the defendants] for his injury" (Pet. App. A11). In the court's view, respondents' complaint did not demonstrate their equal responsibility in this case because "the fraudulent scheme was originated by the broker and his coconspirators to manipulate the market price of T.O.N.M. stock for their financial benefit * * * [and] the investors acted in reliance on [their] representations without knowledge of the true facts" (*id.* at A6).

The court of appeals emphasized that its holding is consistent with "the overall aims of the securities law, and of Rule 10b-5," and, indeed, that application of the *in pari delicto* defense in these circumstances would be "totally incompatible" with those goals (Pet. App. A9). The court reasoned that "[t]o allow professionals in the securities industry and corporate officers to hide behind the *in pari delicto* defense gives them a license to defraud the investing public with little fear of prosecution," because "[s]o long as these persons disseminated false information on the pretext that it was 'inside' information, they would be shielded from liability in a private civil action" (*ibid.*). Because plaintiffs must prove scienter in Rule 10b-5 actions,[3] the court of appeals rejected the notion that its holding would give investors a "warranty of accuracy" with respect to purported inside tips. Such investors, in the court's view, subject themselves to potential civil and criminal liability. Moreover, they "stand[] to lose all of [their] investment. Only in the situation where the investor has been deliberately defrauded will he be able to maintain a private suit in an attempt to recoup his money." *Id.* at A10-A11 n.2.

[3] *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

SUMMARY OF ARGUMENT

The question in this case is whether an action brought by defrauded investors under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder against a securities professional whose manipulative scheme caused their losses should be barred on the ground that they were *in pari delicto* with the defendant. Under the common law, the *in pari delicto* defense is a flexible doctrine applicable only where it will serve the public interest. In the usual case, that interest is best served by applying the defense only when the fault of the parties is relatively equal. Moreover, in light of the federal regulatory context presented by the securities laws, this Court's decision in *Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134 (1968), requires that the *in pari delicto* defense be available only to the extent that it furthers Congress's purpose in the securities laws to protect the investing public.

Consideration of the relative positions of the parties in this action demonstrates that the securities professional was significantly more culpable than the investors he duped. The brokerage firm employee, acting in concert with a corporate insider, originated the manipulative scheme and took advantage of his fiduciary position to defraud his clients. Moreover, this Court's decision in *Dirks* v. *SEC*, No. 82-276 (July 1, 1983), establishes that purported tippees such as the investors here are less culpable than their tippers, because their breach of duty is only derivative of that of the tippers. For these reasons, the *in pari delicto* defense does not bar this suit by investors against the professional who defrauded them.

This result serves to further Congress's goals expressed in the federal securities laws. Private actions such as this one are an important complement to the Commission's own enforcement efforts. Application of the *in*

pari delicto defense in these circumstances would only encourage securities professionals to violate the law by misrepresenting to their clients that they possess material inside information or have inside sources to confirm market rumors. Private actions by defrauded investors will also best deter illegal tippee trading by cutting off the information at its source. This will not encourage investors themselves to engage in illegal trading because they typically trade on tips received only from trusted sources and so do not anticipate recovery in court if the tip turns out to be false. Moreover, the necessity of proving scienter in Rule 10b-5 actions dispels the notion that investors have a "warranty" of the accuracy of a tip. Finally, the substantial sanctions against illegal insider trading ensure that tippees cannot assume that they may trade with impunity.

ARGUMENT

AN EMPLOYEE OF A BROKERAGE FIRM WHO INDUCES INVESTORS TO PURCHASE SECURITIES BY DELIBERATELY MISREPRESENTING THAT HE HAS OBTAINED MATERIAL NONPUBLIC INFORMATION ABOUT THE ISSUER SHOULD NOT BE PERMITTED TO SHIELD HIMSELF FROM DAMAGES LIABILITY UNDER RULE 10b-5 ON THE GROUND THAT THE DEFRAUDED INVESTORS ARE *IN PARI DELICTO* WITH HIM BECAUSE THEY PURCHASED SECURITIES ON THE FALSE PREMISE THAT THEY WERE TIPPEES

This case requires a determination of the circumstances under which a private Rule 10b-5 action against a securities professional should be dismissed under the *in pari delicto* doctrine because the plaintiff's own wrongdoing is relatively equal to the defendant's.[4] The Commission does

[4] See *Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134, 140 (1968); L. Loss, *Fundamentals of Securities Regulation* 1197 (1983) (emphasis omitted) ("[w]hen the [*in pari delicto*] doctrine is considered, one must remember an elementary bit of

not argue that this defense should never apply in private Rule 10b-5 actions. Nor does petitioner argue that the defense should be available irrespective of whether the fault of the parties is relatively equal. Rather, the issue is how to apply the "relatively equal fault" standard, as between an employee of a brokerage firm and the investors he has duped, in order best to effectuate the purposes of the federal securities laws.[5]

The Commission believes that a securities professional should be permitted to invoke the common law *in pari delicto* defense only where the plaintiff's fault is, in fact, substantially equal to or greater than his own—for example, where the plaintiff was involved in an actual conspiracy with the professional to misuse inside information for their mutual benefit or where the plaintiff instigated the professional's violation of law. Because respondents' complaint does not establish such culpability on their part, the court of appeals correctly held that the complaint withstands dismissal on *in pari delicto*

Latin translation sometimes overlooked—that *pari delicto* means equal fault"). The most widely accepted description of the *in pari delicto* defense in cases arising under the federal securities laws requires that the fault of the parties be " 'mutual, simultaneous, and relatively equal.' " *Silverberg* v. *Paine, Webber, Jackson & Curtis, Inc.*, 710 F.2d 678, 691 (11th Cir. 1983), quoting *James* v. *DuBreuil*, 500 F.2d 155, 160 (5th Cir. 1974); *Mallis* v. *Bankers Trust Co.*, 615 F.2d 68, 76 n.6 (2d Cir. 1980), cert. denied, 449 U.S. 1123 (1981).

[5] Petitioner's argument that respondents are *in pari delicto* with its employee Lazzaro would free it of the possibility of derivative liability as a "controlling person" under Section 20(a) of the Act (see page 2, *supra*). Amicus Securities Industry Association (SIA) argues (Br. 20-24), on the other hand, that the *in pari delicto* defense bars the "secondary" liability of a brokerage firm for the fraud of its employee even if the employee himself cannot successfully invoke the defense. Because this issue was not decided by the court of appeals and has not been raised by petitioner either in this Court or in the court of appeals (see *id.* at 20 n.28), the Court need not now decide the question, and the Commission expresses no view on it.

grounds.[6] To allow the defense in the circumstances of this case would have a deleterious impact on compliance with and enforcement of the federal securities laws.

A. The Common Law *In Pari Delicto* Defense Should Be Applied Only Where The Plaintiff's Fault Is, Under All The Circumstances, Relatively Equal To The Defendant's And Application Of The Defense Advances The Objectives Of The Securities Laws

Congress has left to the courts the determination of the role of the *in pari delicto* doctrine in private securities actions under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. See generally *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 389 (1983); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 749 (1975); see also *A.C. Frost & Co.* v. *Coeur D'Alene Mines Corp.*, 312 U.S. 38, 42-45 (1941). At common law, courts have generally rejected the notion, relied on by the district court (Pet. App. C2), that the parties' fault is substantially equal merely because they have engaged in the same type of wrongdoing. Courts have eschewed rigid application of the *in pari delicto* doctrine in favor of a flexible approach that better serves the

[6] The court of appeals did not hold, and we of course do not argue, that a defrauded investor is entitled to recover in these circumstances the profits he would have obtained had the purported inside information been true. See generally *McMullen* v. *Hoffman*, 174 U.S. 639 (1899) (co-conspirators cannot recover profits resulting from their wrongdoing). Rather, the usual "out-of-pocket losses" or rescissory measure of damages should be applied. See, *e.g.*, *Hatrock* v. *Edward D. Jones & Co.*, No. 83-4182 (9th Cir. Dec. 28, 1984), slip op. 5594 n.4. As we demonstrate below (pages 21-30), such relief is fully consistent with public policy. Because it allows the plaintiff to recover only his losses and not his profits, this result does not violate "[t]he principle that a wrongdoer shall not be permitted to profit through his own wrongdoing * * *, [on which] [t]he traditional doctrine of *in pari delicto* is itself firmly based" (*Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134, 151 (1968) (Marshall, J., concurring in the result)).

public interests at stake in each particular case. Courts have reasoned that public policy argues for barring suit only when the fault of the plaintiff is, under all the circumstances, relatively equal to that of the defendant. This Court has likewise relied on public policy considerations in recognizing the limited relevance of the *in pari delicto* defense to private actions brought to enforce rights under a federal regulatory scheme, particularly where the fault of the parties is not relatively equal. *Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134 (1968).

Based upon these principles, the Commission believes that, in private securities actions, a duped investor who trades on what he mistakenly believes to be inside information should not be barred on *in pari delicto* grounds merely because he violates the same statute as the securities professional who defrauded him. This determination is guided by Congress's purposes in enacting the federal securities laws.

1. The *in pari delicto* defense is a common law doctrine denying a plaintiff the right to sue because of the plaintiff's own misconduct where his fault is relatively equal to the defendant's. To ensure that the doctrine properly effectuates public policy, common law courts frequently refused to allow the defense where the culpability of the defendant was substantially greater than that of the plaintiff, judged by the public interests at stake.[7] While the doctrine "'is based on the principle that to give [a wrongdoer] relief * * * would contravene public morals and impair the good of society,'" the public policy principles that support the doctrine also limit its application: the defense must "'not be applied in a case in which to withhold relief would, to a greater extent, offend public morals. To promote the good of the public is the highest aim of the courts in application of this doctrine.'" *Falkenberg* v. *Allen*, 18 Okla. 210, 217, 90 P.

[7] See generally Wade, *Restitution of Benefits Acquired Through Illegal Transactions*, 95 U. Pa. L. Rev. 261 (1947).

415, 418 (1907), quoting *Hobbs* v. *Boatright*, 195 Mo. 693, 715, 93 S.W. 934, 935 (1906). By allowing the less culpable party to recover against the more culpable, the common law courts deterred the primary wrongdoer, who was often the instigator of the illegal conduct, by placing the risk of loss on him.

Because the *in pari delicto* doctrine rests "on public policy considerations," the comparison of the relative fault of the parties is not based on "a neat calculus." *Golberg* v. *Sanglier*, 96 Wash. 2d 874, 883, 639 P.2d 1347, 1353 (1982).[8] Although it is difficult to generalize beyond the overriding public policy requirement concerning the circumstances in which courts will view the parties' fault as relatively equal,[9] certain related principles do follow.

Courts have generally looked to the surrounding circumstances, as well as to the nature of the parties' wrongdoing, in evaluating their relative fault. For example, the plaintiff's fault is not considered equal to the defendant's where the plaintiff "was induced through the fraudulent representations" to engage in an unlawful transaction. 3 J. Pomeroy, *A Treatise on Equity Jurisprudence* § 942a, at 741 (5th ed. 1941); see *National Bank & Loan Co.* v. *Petrie*, 189 U.S. 423, 425 (1903) (the "usual consequence [of fraud] is that as between the parties the one who is defrauded has a right, if possible, to be restored to his former position").[10] Thus, in *Stewart* v. *Wright*, 147 F. 321

[8] See also, *e.g.*, *Stewart* v. *Wright*, 147 F. 321, 329 (8th Cir.), cert. denied, 203 U.S. 590 (1906); *Gilchrist* v. *Hatch*, 183 Ind. 371, 375-377, 106 N.E. 694, 696 (1914); *Hobbs* v. *Boatright*, 195 Mo. at 715, 93 S.W. at 935; *Gorringe* v. *Reed*, 23 Utah 120, 130, 63 P. 902, 904 (1901).

[9] See Wade, *supra*, 95 U. Pa. L. Rev. at 280 ("the conveniently vague doctrine that there may be relief when the parties are not *in pari delicto* provides an acceptable technique for reaching the desired result").

[10] See also, *e.g.*, *National City Bank* v. *Carter*, 31 F.2d 25, 27 (6th Cir.), cert. denied, 280 U.S. 559 (1929); *In re E.J. Arnold & Co.*, 133 F. 789, 792, 793 (E.D. Mo. 1904); *Golberg* v. *Sanglier*, 96

(8th Cir.), cert. denied, 203 U.S. 590 (1906), the court viewed as "altogether too superficial" (147 F. at 332) the contention that the plaintiff was *in pari delicto* with the persons who defrauded him, where the defendants "awakened in [the plaintiff] a desire for wrongful gain that might otherwise have remained dormant, inspired in his mind an unfounded idea that he was going to secure it, and then by fraud and false pretenses deprived him of his money" (*id.* at 328-329). Similarly, in *Sparkman* v. *Triplett*, 292 Ky. 569, 574, 167 S.W.2d 323, 326 (1943), the court concluded that the *in pari delicto* defense should not be extended "to a case in which the defending party had himself first conceived the fraud for his own benefit." Courts have also frequently considered important "the existence of a confidential relationship between the [parties] * * * in determining their relative standing." 3 J. Pomeroy, *supra*, § 942a, at 741.[11] Finally, as petitioner recognizes (Br. 21-22), the defense is applied in those circumstances where it will serve to deter wrongdoing.[12]

Wash. 2d at 886-888, 639 P.2d at 1355; *Grim* v. *Cheatwood*, 208 Okla. 570, 571, 257 P.2d 1049, 1051 (1953); *Thompson* v. *Lyons*, 281 Mo. 430, 453, 220 S.W. 942, 947 (1920); *Brady* v. *Central W.R.R.*, 88 Neb. 840, 842, 130 N.W. 575, 576 (1911); *Falkenberg* v. *Allen*, 18 Okla. 210, 215-219, 90 P. 415, 417-418 (1908); *Lockman* v. *Cobb*, 77 Ark. 279, 288-289, 91 S.W. 546, 550 (1905); *Hess* v. *Culver*, 77 Mich. 598, 601, 43 N.W. 994, 994-995 (1889); *Webb* v. *Fulchire*, 25 N.C. 485, 487 (1843).

[11] See, *e.g.*, *Staufenbiel* v. *Staufenbiel*, 388 Ill. 511, 522-523, 58 N.E.2d 569, 573 (1945); *Harrety* v. *Kontos*, 238 Mo. App. 519, 184 S.W.2d 195 (1944); *Rozell* v. *Vansyckle*, 11 Wash. 79, 85-86, 39 P. 270, 272 (1895); *Barnes* v. *Brown*, 32 Mich. 146, 153 (1875); see also Wade, *supra*, 95 U. Pa. L. Rev. at 276.

[12] The courts therefore consider not merely whether permitting the defense will deter the plaintiff's misconduct but also whether it will unduly encourage wrongful conduct by the defendant (*Stewart* v. *Wright*, 147 F. at 329):

> It would be doubtful wisdom to extend encouragement to organizations of confidence men, who prey upon the public, by allowing them the use of the rule "in pari delicto" as a

These principles preclude the district court's interpretation (Pet. App. C2) that the parties' fault is relatively equal merely because they have violated the same statute,[13] as well as petitioner's related suggestion (Br. 19-20) that a party who has engaged in fraud is in all circumstances barred from recovery for his losses. Petitioner's reliance on *McMullen* v. *Hoffman*, 174 U.S. 639 (1899), and *Meguire* v. *Corwine*, 101 U.S. 108 (1880), is misplaced. In both cases, the Court simply refused to enforce illegal contracts between the parties, where the plaintiffs demanded sums due them under those contracts. Here, by contrast, respondents may recover only the out-of-pocket losses sustained as a result of the defendants' fraud; they may not recover their expected profits (see note 6, *supra*).

2. This Court's decision in *Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134 (1968), underscores the significance of public-policy concerns for application of the *in pari delicto* doctrine. In *Perma Life*, the Court stressed (*id.* at 138) "the inappropriateness of invoking broad common-law barriers to relief where a private suit serves important public purposes" and, accordingly, held (*id.* at 140) that "the doctrine of *in pari delicto*, with its complex scope, contents, and effects is not to be recognized as a defense to an antitrust action."[14] The Court's opinion in *Perma Life* (392 U.S. at 138-140), as well as the separate concurrences of Justices White (*id.* at 143, 146), Fortas (*id.* at 147), and Marshall (*id.* at 148-149), demonstrate the relevance of the federal regulatory scheme under which the plaintiff seeks recovery to a delineation of the role of the *in pari delicto* doctrine.

Justice White, who joined the Court's opinion, wrote separately to express his view (392 U.S. at 143) that the basis for "sorting out those situations in which the plaintiff might be barred because of his own conduct from those in which he may have been a party to an illegal venture but is still entitled to damages from other participants" must lie in "the aims and purposes" of the federal antitrust laws. Justice White concluded (*id.* at 146) that recovery should be denied "where plaintiff and defendant bear substantially equal responsibility for injury resulting to one of them," but permitted where "one is more responsible than the other." Four other Justices would have applied the *in pari delicto* doctrine to antitrust actions, although they stressed the importance of the plaintiff's equal fault as a condition for application of the defense. See *id.* at 147 (Fortas, J., concurring in the result); *id.* at 149 (Marshall, J., concurring in the result); *id.* at 153-155 (Harlan, J., joined by Stewart, J., concurring in part and dissenting in part).

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shield of defense, when a part of the scheme they employ is to place those they seek and then defraud in the position [of wrongdoers] they rely on [for their defense].

[13] While many courts have stated that a plaintiff who violates the same law as a defendant is *in pari delicto* with him, the modern approach is to apply the doctrine in a more flexible manner. See, *e.g.*, *Golberg* v. *Sanglier*, 96 Wash. 2d at 888, 639 P.2d at 1356 (" '[t]he trend of modern jurisprudence is to get away from the technical' " application of the doctrine), quoting *Wright* v. *Stewart*, 130 F. 905, 921 (D. Mo. 1904), aff'd, 147 F. 321 (8th Cir.), cert. denied, 203 U.S. 590 (1906); *National City Bank* v. *Carter*, 31 F.2d at 27; *Tri Q, Inc.* v. *Sta-Hi Corp.*, 63 Cal. 2d 199, 218-219, 404 P.2d 486, 497-498, 45 Cal. Rptr. 878, 889-890 (1965); see generally J. Story, *Commentaries on Equity Jurisprudence* 304-305 (1886); cf. Restatement (Second) of Torts § 889 & comment c (1977). Congress presumably intended that the flexible approach described more fully in the text apply to securities actions, because it better serves the purposes of the securites laws. See *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) ("Congress codified the common law 'remedially' as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not 'technically' as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels."); see also *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 388-389 & nn.27, 28 (1983).

[14] See *American Society of Mechanical Engineers, Inc.* v. *Hydrolevel Corp.*, 456 U.S. 556, 569 (1982) ("In *Perma Life Mufflers*, the Court honored [the purposes of the antitrust laws] by denying defendants the right to invoke a common-law defense (the doctrine of *in pari delicto*) that was inconsistent with the antitrust laws.").

3. Advancement of the purposes of the federal securities laws must, in light of both the common law and *Perma Life*, be the touchstone for application of the defense in this case. As the court stated with respect to Rule 10b-5 actions in *Tarasi* v. *Pittsburgh National Bank*, 555 F.2d 1152, 1162 (3d Cir.), cert. denied, 434 U.S. 965 (1977):

> *Perma Life* teaches that *in pari delicto* should not be applied mechanically when the public interest is present. Rather, it is necessary to assess the impact upon the enforcement of a regulatory system before sanctioning its application.

See also *Kuehnert* v. *Texstar Corp.*, 412 F.2d 700, 704 (5th Cir. 1969) ("The question must be one of policy: which decision will have the better consequences in promoting the objective of the securities laws by increasing the protection to be afforded the investing public."); *Moholt* v. *Dean Witter Reynolds, Inc.*, 478 F. Supp. 451, 453 (D.D.C. 1979) ("[I]t must be determined that the regulatory purpose of the securities laws, protection of the investing public, is best served by allowing rather than disallowing the defense."); *Nathanson* v. *Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50, 52-53 (S.D.N.Y. 1971) (the "basic question" is "what policy with respect to the allowance or disallowance of the defense would best serve to carry out the prime purpose of the securities laws to protect the investing public") (footnote omitted). As at common law, the purposes of the federal securities laws are best achieved by allowing the *in pari delicto* defense only where the fault of the plaintiff, under all the circumstances, is relatively equal to that of the defendant.

Contrary to petitioner's contention (Br. 31-35), the fact that the private right of action for violation of Section 10(b) and Rule 10b-5 is implied rather than express does not make either *Perma Life* or Congress's purposes in enacting the securities laws irrelevant. Nothing in *Perma Life* suggests that the Court's public

policy analysis is limited to express statutory remedies. Moreover, the *in pari delicto* doctrine itself requires an analysis of the public policy implications of applying the defense (see pages 9-10, *supra*).[15] Finally, petitioner fails to acknowledge the importance of implied private actions to enforcement of the securities laws. This Court has consistently noted the significance of "private enforcement [as] * * * 'a necessary supplement to Commission action.'" *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. at 730, quoting *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964). Indeed, in *J.I. Case* (377 U.S. at 432), the Court placed private securities actions on a par with private antitrust actions insofar as they contribute to assuring compliance with the underlying statute. And the Court has not hesitated, where necessary, to depart from technical common law limitations in construing the securities laws. See *Herman & MacLean* v. *Huddleston*, *supra* (common law standard of clear and convincing evidence does not apply to private actions under Section 10(b)); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) ("Congress intended * * * securities legislation 'enacted for the purpose of avoiding frauds'" to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes") (footnote omitted). So here. Our submission does not repudiate the common law, but—consistently with both the common law and *Perma Life*—we urge that furtherance of public policy, here embodied in the Securities Exchange Act, be the goal in application of

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[15] Petitioner's invocation (Br. 35) of the common-law savings clauses in the securities statutes is therefore irrelevant. Petitioner admits (Br. 28 nn.21, 22) that the Court's analysis in *Perma Life* may be regarded as consistent with the common law *in pari delicto* doctrine. In our view, *Perma Life* serves, in a regulatory context such as the securities area, to focus the courts' attention on the purposes of the regulatory scheme in considering the role, if any, of the defense. This is completely consistent with the common law's emphasis on public policy considerations in applying the doctrine.

the *in pari delicto* doctrine, and that public policy is best furthered by applying the defense only where the fault of the parties is relatively equal.[16]

B. Because The Securities Professional In This Case Was Far More Culpable Than The Victims Of His Manipulative Scheme, He Cannot Avoid Liability Under The *In Pari Delicto* Doctrine

1. Before addressing the question whether the fault of respondents was relatively equal to that of petitioner's employee, it is necessary to consider whether respondents were at fault at all. In *Dirks* v. *SEC*, No. 82-276 (July 1, 1983), the Court held that a tippee does not violate Rule 10b-5 when trading on inside information merely by "knowingly receiv[ing] nonpublic material information from an insider" (slip op. 9). Rather, a tippee inherits from his insider source a duty to disclose or to abstain from trading only when the insider himself has violated his fiduciary duty to shareholders by disseminating corporate information *and* where the tippee knows or should know of the insider's breach of duty (*Dirks*, slip op. 13). "All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders" (*id.* at 15), even when there is "reason to believe

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[16] See page 14, *supra*; *Chemetron Corp.* v. *Business Funds, Inc.*, 682 F.2d 1149, 1182 (5th Cir. 1982), vacated and remanded on other grounds, 460 U.S. 1007 (1983), quoting *Woolf* v. *S.D. Cohn & Co.*, 515 F.2d 591, 604, on reh'g, 521 F.2d 225 (5th Cir. 1975), vacated and remanded on other grounds, 426 U.S. 944 (1976):

> "[E]ven in a case where the fault of plaintiff and defendant were relatively equal, simultaneous and mutual, the court might still reject the [*in pari delicto*] defense if it appeared that the defendant's unlawful activities were of a sort likely to have a substantial impact on the investing public, and the primary legal responsibility for and ability to control that impact is with defendant."

See also *Mallis* v. *Bankers Trust Co.*, 615 F.2d 68, 76 n.6 (2d Cir. 1980), cert. denied, 449 U.S. 1123 (1981).

that * * * outsider[s] may use it to the disadvantage of the shareholders" (*id.* at 19 n.27). The test is "whether the insider personally will benefit, directly or indirectly, from his disclosure" (*id.* at 15), by receiving, for example, "a pecuniary gain or a reputational benefit that will translate into future earnings" (*id.* at 17). The insider likewise could benefit by making "a gift of confidential information to a trading relative or friend" (*ibid.*).[17]

Judged by these standards, it is not clear on the face of respondents' complaint that they are guilty of an attempted violation of Rule 10b-5 under traditional notions of tippee liability for having traded on the mistaken assumption that Lazzaro was privy to information emanating from a corporate insider (see J.A. 11).[18] In evaluating respondents' conduct under an attempt theory, the Court must "assume the facts as the [respondents] thought them to be when engaging in their allegedly wrongful conduct." *Schick* v. *Steiger*, 583 F. Supp. 841, 847 (E.D.

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[17] The insider's breach and the tippee's knowledge can of course be established by circumstantial evidence (see *Dirks*, slip op. 16).

[18] There is no basis for concluding that respondents actually violated Rule 10b-5. Petitioner argues repeatedly (Br. 3, 8, 12, 13, 15, 16, 43) that respondents traded not just on fabricated information but also on "actual" inside information. But the complaint, construed in a light most favorable to respondents, alleges that all of the potentially material information on which respondents traded was fabricated. In the court of appeals, moreover, petitioner argued that "the undisputed allegations of the Complaint demonstrate that no true inside information was disseminated by Lazzaro" (Appellees' C.A. Br. 17 n.12). The courts likewise analyzed the *in pari delicto* defense here on the premise that respondents traded on "false information" (Pet. App. C2) that was provided to them "on the pretext that it was inside information" (*id.* at A2). In our view, whether the information was or was not false is not directly relevant to whether respondents had reason to believe that Neadeau, the insider, had violated a fiduciary duty by transmitting the information to Lazzaro. Moreover, it is not clear that false information could be "material" for purposes of an actual insider trading violation.

Mich. 1984).[19] Obviously, respondents were unaware that Neadeau stood to profit from stock manipulation, for they believed his information to be true. Further, respondents had no reason to suspect that Neadeau's purpose in disclosing the information to Lazzaro was to drive upward the price of TONM stock. If that had been his purpose, he presumably would have issued a press release announcing the company's good fortune. Although respondents might have believed that Neadeau had provided the information as a gift to Lazzaro or otherwise had violated his fiduciary obligations to the shareholders, respondents' complaint does not admit facts conclusively showing this to be the case. Because all doubts must be resolved in respondents' favor on the motion to dismiss, it may well be that respondents should not at this stage be considered guilty of an attempted violation of Rule 10b-5. See *Wager* v. *Pro*, 575 F.2d 882, 884-885 (D.C. Cir. 1976).[20]

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[19] See also Wechsler, Jones, & Korn, *The Treatment of Inchoate Crimes in the Model Penal Code of the American Law Institute: Attempt, Solicitation, and Conspiracy*, 61 Colum. L. Rev. 571 (1961); Model Penal Code § 5.01(1)(a) (Proposed Official Draft 1962) ("A person is guilty of an attempt to commit a crime if, acting with the kind of culpability otherwise required for commission of the crime, he * * * purposely engages in conduct which would constitute the crime if the attendant circumstances were as he believes them to be.").

[20] Petitioner's argument (Br. 15) that respondents knew that Neadeau violated a duty by revealing purported inside information to Lazzaro rests entirely on the premise that any revelation of inside information violates the insider's duty, a premise the Court expressly rejected in *Dirks*. The Court noted in *Dirks* that an insider may "act consistently with his fiduciary duty to shareholders" by "disclos[ing] information to analysts" even where "release of the information may affect the market" (slip op. 15)—indeed, that was precisely the situation in *Dirks* itself. Petitioner's reliance (Br. 16, 46) on cases decided before *Dirks* is misplaced. In *Tarasi* v. *Pittsburgh National Bank*, 555 F.2d 1152, 1161 (3d Cir.), cert. denied, 434 U.S. 965 (1977), for example, the court erroneously assumed that a tippee violates Rule 10b-5 merely by

2. a. Even if respondents did violate or attempt to violate Rule 10b-5, their conduct was far less culpable than that of Lazzaro when measured by traditional common law precepts developed under the *in pari delicto* doctrine. Lazzaro originated the scheme to manipulate the market in TONM securities without respondents' participation or knowledge. While respondents were not coerced into trading on TONM stock, they were duped by Lazzaro solely for his own benefit (along with that of his coconspirator Neadeau). At common law, Lazzaro would not be able to take advantage of the *in pari delicto* defense because of his greater fault in conceiving the fraudulent scheme for his own benefit, as compared to the fault of the victims he lured into trading on what they believed to be inside information (see pages 10-11, *supra*).

Of equal significance under the common law, Lazzaro took advantage of his fiduciary relationship as a securities professional[21] to defraud his clients. Fraud by such

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trading while in possession of undisclosed inside information. Petitioner's attempt (Br. 17 n.12) to distinguish recent cases holding that the *in pari delicto* defense is inapplicable where a purported tippee is defrauded by a person who is not an insider or acting in concert with one is unpersuasive, for petitioner has not shown how respondents' complaint admits facts putting them on notice of the insider's breach. See *Silverberg* v. *Paine, Webber, Jackson & Curtis, Inc.*, 710 F.2d 678, 691 (11th Cir. 1983); *Wise* v. *Kidder Peabody & Co.*, 596 F. Supp. 1391, 1395 (D. Del. 1984); *Schick* v. *Steiger*, 583 F. Supp. 841, 846-848 (E.D. Mich. 1984); *Wilkinson* v. *Paine, Webber, Jackson & Curtis, Inc.*, 585 F. Supp. 23, 25 (N.D. Ga. 1983); *Xaphes* v. *Shearson, Hayden, Stone, Inc.*, 508 F. Supp. 882, 885-887 (S.D. Fla. 1981). But see *Summerlin* v. *Blyth Eastman Dillon & Co.*, [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197 (N.D. Ga. Mar. 23, 1983). It would make little sense to adopt petitioner's approach, which would allow brokers to avoid liability if they artfully suggest an insider source for their information.

[21] See *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017, 1026 (6th Cir. 1979); *Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); S. Jaffe, *Broker-Dealers and Securities Markets* § 7.09 (1977); N. Wolfson, R.

a fiduciary who owes special duties to his clients is more blameworthy and more serious in its implications than is fraud by an ordinary investor.[22] A securities salesperson is responsible for ensuring that he does not induce unlawful trading by his customers. He is in a far better position than his customers to determine whether information he provides to them is legally available for use under *Dirks*—a "question of fact" that is "not always * * * easy [even] for courts" to decide (*Dirks*, slip op. 17). A customer might trade on nonpublic information provided to him by his broker without knowing that his use of the information is unlawful under *Dirks*.[23] While the customer's ignorance of the law would be no defense in an action against him by the Commission, it is a relevant factor in assessing the relative culpability of the customer and his broker.

b. Both this Court and Congress have also made clear that tippees are less culpable than their tipper sources. As noted above (pages 16-17), the Court held in *Dirks* that a tippee's duty is "derivative from * * * the insider's duty" (slip op. 12). Thus, even if respondents did at-

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Phillips & T. Russo, *Regulation of Brokers, Dealers and Securities Markets* ¶ 2.03 (1977 & Supp. 1984); 5B A. Jacobs, *Litigation and Practice Under Rule 10-5* § 210.03 (2d rev. ed. 1984).

[22] Petitioner's (Br. 43-46) and amicus Securities Industry Association's (SIA's) (Br. 8-19) arguments to the contrary lack merit. That Rule 10b-5 applies to "any person" does not mean that an investor who violates the Rule is necessarily as blameworthy as a securities professional who violates it. The application of Rule 10b-5 to "any person" is intended to ensure that it sweeps broadly to capture all potential violators; the language certainly was not intended to eliminate distinctions between the relative culpability of differently situated violators. A securities professional does bear a special fiduciary relationship to his customers. His customers do not owe such a reciprocal duty to him. This relationship between the parties is significant for assessment of the parties' relative fault under the *in pari delicto* doctrine (see page 11, *supra*).

[23] See Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 Vand. L. Rev. 1273, 1279 n.26 (1984).

tempt to violate Section 10(b) and Rule 10b-5, their role as "'participant[s] after the fact in the insider's breach of a fiduciary duty'" (*Dirks*, slip op. 12, quoting *Chiarella* v. *United States*, 445 U.S. 222, 230 n.12 (1980)) cannot make their culpability equal to that of Lazzaro, who, acting in concert with Neadeau, violated a direct duty owed to TONM's shareholders.

Similarly, Congress, in enacting the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 *et seq.*, imposed a civil penalty on nontrading tippers (§ 2, 98 Stat. 1264) on the premise that tippers are the parties most responsible for any fraud on the investing public:

> "Tippers" often obtain material nonpublic information as a result of a position of trust and confidence. Absent the tipper's misconduct, the tippee's trading would not occur. Thus, the new civil penalty would be imposed upon *those persons most directly culpable in a violation.*

H.R. Rep. 98-355, 98th Cong., 1st Sess. 9 (1983) (emphasis supplied).

C. Allowing Duped Investors To Recover Their Trading Losses From The Securities Professional Who Defrauded Them Promotes The Purposes Of the Federal Securities Laws

Aside from the substantially greater fault of the securities professional in this case, the *in pari delicto* doctrine should not be applied here because allowing actions by duped investors such as respondents to go forward will further the public interest as expressed by Congress in the federal securities statutes. The cases relied on by petitioner (Br. 25 & n.17) uphold the defense against purported tippees in the belief that such a course will best deter illegal tippee trading.[24] But we submit that

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[24] See *Wolfson* v. *Baker*, 623 F.2d 1074, 1082 (5th Cir. 1980), cert. denied, 450 U.S. 966 (1981); *Tarasi* v. *Pittsburgh National Bank*, 555 F.2d at 1159, 1162-1164; *Malamphy* v. *Real-Tex Enterprises, Inc.*, 527 F.2d 978, 980 (4th Cir. 1975) (relying on Fifth

the sounder view is that of the courts that have found the defense unavailable on the reasoning that this result will best deter insiders and brokers from tipping both false and true information.[25]

The Commission believes that the court of appeals in this case was correct in concluding (Pet. App. A9) that barring respondents' Rule 10b-5 action on *in pari delicto* grounds would be "totally incompatible with the overall aims of the securities laws, and of Rule 10b-5."[26] Private actions such as this one are essential to effectuate Congress's intent to hold securities professionals to high ethical standards and to discourage fraudulent and manipulative activities on the part of those professionals. Further, allowing these suits to go forward will not undermine deterrence of illegal tippee trading, but rather will further the goal of preventing such activity.

Circuit precedent); *James* v. *DuBreuil*, 500 F.2d 155, 160 (5th Cir. 1974); *Kuehnert* v. *Texstar Corp.*, 412 F.2d at 704-705; *Grumet* v. *Shearson/American Express, Inc.*, 564 F. Supp. 336, 341 (D.N.J. 1983); *Kirkland* v. *E.F. Hutton & Co.*, 564 F. Supp. 427, 435-437 (E.D. Mich. 1983); *In re Haven Industries, Inc.*, 462 F. Supp. 172, 180 (S.D.N.Y. 1978); *Summerlin* v. *Blyth Eastman Dillon & Co.*, [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197, at 95,793.

[25] See Pet. App. A6-A10; *Moholt* v. *Dean Witter Reynolds, Inc.*, 478 F. Supp. at 453; *Nathanson* v. *Weis, Voisin, Cannon, Inc.*, 325 F. Supp. at 53-58; see also *Kuehnert* v. *Texstar Corp.*, 412 F.2d at 705-707 (Godbold, J., dissenting).

[26] The Commission's prediction concerning the likely enforcement consequences of not applying the *in pari delicto* defense in suits by defrauded tippees is entitled to deference: " 'a forecast of the direction in which future public interest lies necessarily involves deductions based on the expert knowledge of the agency.' " *FCC* v. *National Citizens Committee for Broadcasting*, 436 U.S. 775, 814 (1978), quoting *FPC* v. *Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1, 29 (1961). See generally *SEC* v. *New England Electric System*, 390 U.S. 207, 211 (1968); *United States* v. *Shimer*, 367 U.S. 374, 382 (1961); *SEC* v. *Chenery Corp.*, 332 U.S. 194 (1947); *American Power & Light Co.* v. *SEC*, 329 U.S. 90, 112 (1946). While cases raising the question of deference to agency expertise normally arise in the context of review of administrative

1. *Denial Of The* In Pari Delicto *Defense In This Case Promotes Congress's Purpose To Impose High Ethical Standards On Securities Professionals And To Deter Them From Engaging In Fraudulent And Manipulative Schemes*

In enacting the federal securities laws, Congress intended to protect investors and the economy as a whole by imposing " 'a high standard of business ethics * * * *in every facet of the securities industry.*' " *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979), quoting *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. at 186-187 (emphasis in original); see also *Herman & MacLean* v. *Huddleston*, 459 U.S. at 389 ("an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry"). Congress was particularly concerned in the Securities Exchange Act with the ability of brokers and dealers to manipulate securities markets through circulation of false information.[27] Congress therefore prohibited brokers and dealers from engaging in such practices with securities traded on national exchanges, and it made them liable in damages to investors injured by such prac-

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orders or rules, the same principle should apply here, where the direction in which the public interest lies is peculiarly within the Commission's specialized purview.

[27] The Senate hearings and report on stock exchange practices that formed the basis for the Act documented the practices of brokers manipulating the price of securities for their own benefit, as alleged in this case, by disseminating misleading information concerning those securities to their customers. S. Rep. 1455, 73d Cong., 2d Sess. 41-45 (1934). Such practices, the Senate concluded (*id.* at 43), "[could] not be condemned more severely." See *Stock Exchange Practices: Hearings on S. Res. 84, S. Res. 56 and S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. 5895-5904 (1934); see also *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 195 (1976) (noting that a principle objective of the Securities Exchange Act was "to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets").

tices. See Section 9(a)(3)-(5) and (e) of the Act, 15 U.S.C. 78i(a)(3)-(5) and (e). And securities professionals are of course subject to the antifraud provisions of Section 10(b) of the Act and Rule 10b-5.

a. The private Rule 10b-5 action importantly contributes to achieving Congress's goal by deterring fraudulent practices by professionals in the brokerage industry—the professionals who play the most critical role in maintaining the integrity of the securities markets.[28] Rule 10b-5 actions are particularly significant in deterring brokerage professionals from misrepresenting to customers that they have "sources" to verify market rumors and from otherwise fabricating "tips" of supposed nonpublic information. See, *e.g.*, *Hatrock* v. *Edward D. Jones & Co.*, No. 83-4182 (9th Cir. Dec. 28, 1984) (brokerage firm employee found to have feigned calling a nonexistent "source" in his customer's presence to induce stock purchase). Private actions are common under Rule 10b-5 against securities salesmen who allegedly have used false suggestions or direct misrepresentations that they have "inside" information to induce customers to purchase securities, thereby earning commissions for themselves. See, *e.g.*, *Moholt* v. *Dean Witter Reynolds, Inc.*, 478 F. Supp. at 453 ("the Court takes judicial notice of a tendency on the part of brokers to suggest or intimate that they are in possession of information not generally available"); *Nathanson* v. *Weis, Voisin, Cannon, Inc.*, 325 F. Supp. at 51; *Kirkland* v. *E.F. Hutton & Co.*, 564 F. Supp. 427, 432 (E.D. Mich. 1983); *In re Haven Industries, Inc.*, 462 F. Supp. 172, 173-177 (S.D.N.Y. 1978). The court of appeals correctly recognized (Pet. App. A9) that indiscriminate use of the

[28] See *Nathanson* v. *Weis, Voisin, Cannon, Inc.*, 325 F. Supp. at 54; *Moholt* v. *Dean Witter Reynolds, Inc.*, 478 F. Supp. at 453; see also *Fratt* v. *Robinson*, 203 F.2d 627, 632 (9th Cir. 1953) ("[N]othing * * * would more certainly tend to deter fraudulent practices in security transactions * * * than the right of defrauded sellers or buyers of securities to seek redress in damages in federal courts."); see also page 20, *supra*.

in pari delicto defense would effectively shield such fraudulent practices from private suit. Under the per se approach advocated by petitioner, a brokerage firm salesman might protect himself from private actions by his customers by falsely representing that the source of his "tip" is an "insider" friend (*ibid.*).

Although brokerage firm salespersons are subject to criminal and civil governmental sanctions for engaging in such dishonest practices, these practices would, in the Commission's view, go largely undetected in the absence of private suits under Rule 10b-5. "[L]itigation among guilty parties serves to expose their unlawful conduct and render them more easily subject to appropriate civil, administrative, and criminal penalties." *Kuehnert* v. *Texstar Corp.*, 412 F.2d at 706 n.3 (Godbold, J., dissenting); see Comment, *Securities Regulation—In Pari Delicto as a Bar to Private Antifraud Action by Tippee against Tipper*, 43 Mo. L. Rev. 378, 386 (1978). Without the prospect of recovering his losses, an investor defrauded by a false tip has little incentive to expose the broker's wrongdoing because, by doing so, he exposes his own potentially illegal conduct.

Without the tippees' assistance, the Commission could not effectively prosecute false tipping—a difficult practice to detect. Indeed, amicus SIA argues (Br. 24) that fraudulent practices by securities salespersons are difficult to uncover even by their own brokerage firms. But, however that may be, the Commission does not have the resources to police the industry sufficiently to ensure that false tipping does not occur or is consistently discovered.[29] The court of appeals correctly concluded (Pet. App. A9) that allowing professionals to use the *in pari delicto*

[29] Phillips, *When a Broker Takes a Client for a Ride*, Bus. Wk. Feb. 25, 1985, at 87 (the Commission has stated that "the agency has the resources to handle only 'truly egregious cases.'").

defense "gives them a license to defraud the investing public with little fear of prosecution."

b. Congress's intent to subject securities brokers to liability in cases such as this is shown especially clearly in Section 9(e) of the Securities Exchange Act (15 U.S.C. 78i(e)). Section 9(e) overrides the common law rule denying coconspirators a right to contribution, which rests on the theory that "parties generally *in pari delicto* should be left where they stand." *Texas Industries, Inc.* v. *Radcliff Materials, Inc.*, 451 U.S. 630, 635 (1981); see Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597, 647-648 (1972). This provision makes all willful participants in prohibited conduct subject to monetary liability, allowing a securities broker held liable under Section 9 to seek contribution from "any person who, if joined in the original suit, would have been liable to make the same payment." [30] As with Section 9(e), the court of appeals' decision in this case effectuates Congress's enforcement goal by ensuring that every participant in a manipulation is subject to monetary liability. Surely, the Congress that provided that a brokerage professional such as Lazzaro could recover from his fellow manipulators should be understood to have also permitted the victims of Lazzaro's manipulative scheme to sue him.[31]

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[30] See also Section 18(b) of the Securities Exchange Act (15 U.S.C. 78r(b)); Section 11(f) of the Securities Act of 1933 (15 U.S.C. 77k(f)); 3 L. Loss, *Securities Regulation* 1739-1740 n.178 (2d ed. 1961).

[31] Petitioner argues (Br. 21) that "public confidence in the judicial process" will be undermined by allowing suits by persons such as respondents in this case. Allowing suits by persons who are less blameworthy than those they sue, suits that will advance the purposes of the securities laws, will in no way undermine public confidence in the integrity of the courts. Indeed, Congress obviously did not believe that allowing suit by a securities manipulator for contribution under Section 9(e) would undermine judicial integrity, even where the manipulator's fault is equal to that of the person he has sued.

2. *Denial Of The* In Pari Delicto *Defense In This Case Will Best Achieve Congress's Objective To Deter Illegal Tippee Trading*

There is no dispute that allowing suits such as this one to go forward will most directly deter fraudulent practices by securities salespersons.[32] The lower courts are divided, however, as to the likely effect on illegal tippee trading of allowing or not allowing the *in pari delicto* defense in circumstances such as these (see cases cited at notes 24-25, *supra*). Those courts that have applied the defense do recognize that "if a tippee has no remedy against an insider's private falsehoods, little deterrent against [the insider's misconduct] will exist" (*Kuehnert* v. *Texstar Corp.*, 412 F.2d at 705). But they reason that sacrificing the deterrent of private actions against insiders and securities professionals is necessary to discourage tippees from trading, on the theory that "[i]f a tippee can sue he has, in effect, an enforceable warranty that secret information is true" (*ibid.*). The Commission disagrees.

The Commission is of the view that illegal tippee trading is best deterred by cutting off true or purported inside information at the source—insiders and brokerage professionals. This goal is accomplished most directly by allowing suits such as this one to go forward. We believe that Judge Weinfeld reasoned correctly in *Nathanson* v. *Weis, Voisin, Cannon, Inc.* as follows (325 F. Supp. at 57-58, quoting *Kuehnert* v. *Texstar Corp.*, 412 F.2d at 706 (Godbold, J., dissenting)):

> The true insider or the broker-dealer is at the fountainhead of the confidential information * * *. If the prophylactic purpose of the law is to restrict the use of all material inside information until it is made available to the investing public, then the most effective means of carrying out this policy is to nip in the bud the source of the information, the tipper, by discouraging him from "making the initial dis-

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[32] See, *e.g.*, *Tarasi* v. *Pittsburgh National Bank*, 555 F.2d at 1163 ("[t]he absence of this defense would have the greatest impact on deliberate purveyors of false information").

closure which is the first step in the chain of dissemination." This can most readily be achieved by making unavailable to him the defense of in pari delicto when sued by his tippee upon charges based upon alleged misinformation.

Corporate insiders and broker-dealers are not only the sources of inside information, they are also the persons most likely to respond to deterrence. They are more likely than ordinary investors to be advised by counsel and to be aware of the legal limitations on the use of nonpublic information in their possession. *Kuehnert*, 412 F.2d at 706 (Godbold, J., dissenting); *Nathanson*, 325 F. Supp. at 57-58. Private actions against them are therefore a most effective means of deterring their transgressions.

On the other hand, it is unrealistic to suppose that the bar to recovery erected by the *in pari delicto* defense has any substantial deterrent effect on the illegal use of inside information by tippees. Because investors typically receive nonpublic information from sources they trust, it is unlikely that tippees trade in anticipation of recovery against their sources if the information proves false.[33] And because investors are often unsophisticated and uncounselled, it is doubtful indeed whether, even if they considered possible recovery in a private action, the doctrine of *in pari delicto* would ever enter into their decisions.

Further, this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), has significantly undermined the notion that the tippee has an enforceable warranty of recovery if he is allowed to bring suit in cases such as this one, because a plaintiff in a Rule 10b-5

[33] See Comment, *Rule 10b-5: The In Pari Delicto and Unclean Hands Defenses*, 58 Cal. L. Rev. 1149, 1159 & n.49 (1970) ("It is unlikely that the tippee would be deterred from using information gained from an insider by the knowledge that he could not recover from the insider. In most instances, tippees will have taken the tip from someone they trust, and therefore will not doubt the person's word. The tippee just wants to make money and does not think of possible adverse consequences."); Comment, *supra*, 43 Mo. L. Rev. at 384.

action must now prove that the defendant acted with scienter.[34] Thus, even if a tippee might consider, prior to trading, the prospects of recovering from his source should the information turn out to be false, he would have no assurance of recovery. As the court of appeals concluded, (Pet. App. A10-A11 n.2) "if the tip merely fails to 'pan out' or if the information itself proves accurate but the stock fails to move in the anticipated direction, the investor stands to lose all of his investment. Only in the situation where the investor has been deliberately defrauded will he be able to maintain a private suit in an attempt to recoup his money."

Nor can tippees assume that their potential liability is minimal. In recent years, numerous tippees have been the subject of well-publicized governmental and private actions.[35] The Insider Trading Sanctions Act of 1984 now imposes (§§ 2-3, 98 Stat. 1264-1265) substantial sanctions on persons who have used information illegally, including a civil penalty of three times the profits gained or losses avoided through illegal use of inside information, as well as criminal fines of up to $100,000. Like the plaintiffs in *Perma Life*, tippees are now "fully subject to civil and criminal penalties for their own illegal conduct" (392 U.S. at 139).

Finally, even if application of the *in pari delicto* doctrine did to some extent deter tippee trading, the Commission believes that this benefit is far outweighed by the accompanying loss in deterrence of fraudulent brokerage industry practices. Securities professionals are continually in a position to engage in fraudulent practices involving real and fictitious inside information. Tippees, on the other hand, are often nonprofessional investors who are rarely in a position to obtain or use inside information. "As between the broker-dealer * * * and the tippee, * * * the broker-dealer presents a

[34] This Court has noted the difficulty plaintiffs face in attempting to establish scienter. *Herman & MacLean* v. *Huddleston*, 459 U.S. at 390-391 n.30.

[35] See Langevoort, *supra*, 37 Vand. L. Rev. at 1275.

greater potential threat to undermining the statutory protection intended for the public investor." *Nathanson* v. *Weis, Voisin, Cannon, Inc.*, 325 F. Supp. at 57; see *Moholt* v. *Dean Witter Reynolds, Inc.*, 478 F. Supp at 453 ("[i]n the complex, highly regulated securities field, primary responsibility must rest on licensed brokers and their employees in order to achieve maximum conformance with federal statutes and implementing regulations"). We agree with the court of appeals (Pet. App. A9) that any benefit achieved "through imposition of the *in pari delicto* defense [in cases such as this one] is outweighed by the resulting adverse consequence to the market and innocent investors."

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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In The Supreme Court
Of The United States

October Term 1984

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED, Petitioner,

vs.

CARL F. BERNER, et al., Respondents.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

BRIEF FOR RESPONDENTS

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PETITION FOR CERTIORARI FILED OCTOBER 24, 1984; CERTIORARI GRANTED JANUARY 7, 1985

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QUESTIONS PRESENTED

1. Is there a need for an *in pari delicto* defense in an action brought by a "tippee" against his "tipper" under the antifraud provisions of the federal securities law after this Court's decisions in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), *Chiarella v. United States*, 445 U.S. 222 (1980) and *Dirks v. SEC*, 463 U.S. 646, 103 S.Ct. 3255 (1983)?

2. Assuming that a broker or corporate insider has encouraged investors to purchase securities based upon a representation that the investors are being given "non-public" information and such information is false and was made with the degree of *scienter* for which there would be liablity under this Court's decision in *Ernst & Ernst*, are the duped investors ever *in pari delicto*?

3. Is the defense of in pari delicto inappropriate as the sole basis for dismissal of a complaint in a private action under the federal securites laws, unless the alleged facts show that the investor is equally responsible for his injury? 1/

1/ Respondents-plaintiffs on whose behalf this brief is filed are Carl F. Berner, Charles Bruner, Dennis T. Demetre, Lawrence Epstein, Barry S. Glass, Herbert Greenbaum, Robert M. Jacobs, Arnold R. Keiles, Harry Mittleman, and Gary L. Nobel. Charles P. Lazzaro, Leslie L. Neadeau, and T.O.N.M. Oil & Gas Exploration Corporation, identified in the caption as respondents, are defendants.

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No. 84-679

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On Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

BRIEF FOR RESPONDENTS

STATEMENT OF THE CASE

Plaintiffs brought this action to recover damages arising out of their purchase of stock in T.O.N.M. Oil & Gas Exploration Corporation ("T.O.N.M."). The complaint was filed on December 10, 1982. (J.A. 1.) 2/

Plaintiffs' complaint alleged that, commencing in November, 1979, Bateman Eichler, Hill Richards, Incorporated ("Bateman Eichler"), a broker-dealer, Charles P. Lazzaro, its registered representative, T.O.N.M., a public corporation, and Leslie L. Neadeau, its president, engaged in a scheme to manipulate the market price of T.O.N.M. stock by disseminating false information on the pretext that it was "not public" information. (J.A. 10-15, Complaint ¶¶ 16, 23,

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2/ The J.A. references are to the Joint Appendix, with the number referring to the page number.

29.) This scheme involved representations concerning the business prospects for T.O.N.M. and the relationship between Lazzaro and T.O.N.M. (J.A. 10-13, Complaint ¶¶ 15-17, 19-22.) The representations are alleged to have been made by the defendants with the intention of inducing purchases of T.O.N.M. stock by plaintiffs for the purpose of creating an artificially high demand and price for T.O.N.M. stock. (J.A. 10-12, 15-16, Complaint ¶¶ 16, 29, 3/ 31, 34.) The representations are alleged to be false

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3/ Paragraph 29 of the complaint alleges that all defendants were involved in the misrepresentations to plaintiffs. Thus, although plaintiffs have alleged that Bateman Eichler has "control liability" as well (J.A. 7, 16, Complaint ¶¶ 5, 16-17), it would be inappropriate to draw a distinction at the pleading stage between the availability of in pari delicto for the representative and the brokerage house. For example, proof might show that the brokerage house was making a market in the stock.

(J.A. 15, Complaint ¶ 30) or materially incomplete (J.A. 15-16, Complaint ¶ 33). 4/ The defendants are alleged to have known the falsity of the representations. (J.A. 15, Complaint ¶ 32). The plaintiffs are alleged to have purchased

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4/ Bateman Eichler refers to the plaintiffs as having "actual" inside information throughout its argument. See, e.g., Brief of Petitioner at 12, 13, 15. The allegations of the complaint speak for themselves and the thrust of the allegations is that the information provided to plaintiffs was knowingly and intentionally false. (J.A. 13-14, 15, Complaint ¶¶ 23, 30, 32.) Plaintiffs' allegation that "T.O.N.M. announced that the negotiations for a joint venture had terminated and that no new negotiations were contemplated" (J.A. 13, Complaint ¶ 20) referred to by Bateman Eichler as support for its argument that plaintiffs had actual inside information (Brief of Petitioner at 15) does not establish that any such joint venture existed. In fact, that announcement would appear to be the perfect exit line for defendants' intentional manipulation. Nor does an allegation that plaintiffs were falsely advised that they were getting non-public information establish that the information was in fact non-public.

T.O.N.M. stock in reliance on defendants' misrepresentations and as a result of their unlawful scheme. (J.A. 10, 17, Complaint ¶¶ 15, 41a.) Plaintiffs' purchases of T.O.N.M. stock were made through the mechanism of the National Association of Securities Dealers over-the-counter system ("NASDAO"), a national securites exchange. (J.A. 10, Complaint ¶ 14.) And, finally the scheme produced a substantial manipulation in the price of T.O.N.M. stock. (J.A. 10, Complaint ¶¶ 14, 23.)

In short, plaintiffs alleged that they were used by defendants, without their knowledge, in an effort by defendants to manipulate the securities market in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") (15 U.S.C. § 78j(b)), Securities and Exchange Commission Rule 10b-5

(17 C.F.R. 240.10b-5) and Section 17(a) of the Securities Act of 1933 ("Securities Act") (15 U.S.C. § 77q). 5/

The district court dismissed these claims under the doctrine of in pari delicto holding that "if the allegations of the complaint are true, both plaintiffs and defendants violated the particular statutory provision under which recovery is sought." (Pet. App. C-2, Order.)

Plaintiffs appealed the district court's decision and the Ninth Circuit reversed and remanded for a trial on the merits, holding:

> "We have concluded that the defense of in pari delicto is inappropriate as the sole basis for the dismissal of a complaint, in a private action under the federal securities

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5/ Plaintiffs raised additional claims that are not now in issue.

> laws, unless the alleged facts show that the investor is equally responsible for his injury. Where the pleaded facts show that the investor suffered a loss because he relied upon a broker's fraudulent misrepresentations, a cause of action has been stated which may be answered by denial or barred by pleading and proving an affirmative defense."

Pet. App. A-11, Opinion.

Bateman Eichler contends that, contrary to the law established by the courts of appeals in every other circuit which has considered the issue [6/] and contrary to the deep-rooted tradition of the common law, the Ninth Circuit

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6/ The Third Circuit in Tarasi v. Pittsburg National Bank, 555 F.2d 1152 (3d Cir.), cert. denied, 434 U.S. 965 (1971); the Fourth Circuit in Malamphy v. Real-Tex Enterprises, Inc., 527 F.2d 978 (4th Cir. 1975); the Fifth Circuit in Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969); and the Eleventh Circuit in Silverberg v. Paine, Webber, Jackson & Curtis, Inc., 710 F.2d 678 (11th Cir. 1983).

decision has eliminated the in pari delicto defense in actions brought under Section 10(b) of the Exchange Act against broker defendants. It is apparent from the holding of the Ninth Circuit set forth above that this contention is greatly overstated.

The decision of the Ninth Circuit herein did not "sweep away" the in pari delicto defense. Rather, it recognized the defense, but held that "equal fault" within the meaning of the defense could not exist as a matter of law if the plaintiffs proved that they were used unknowingly by the broker defendants as part of a scheme to manipulate the market in certain securities as alleged in their complaint.

> "In the matter before us, the complaint alleges that the fraudulent scheme was originated by the broker and his coconspirators to manipulate the

market price of T.O.N.M. stock for their financial benefit. The complaint further provides that the investors acted in reliance on these representations without knowledge of the true facts. The allegations of the complaint, if proved, would demonstrate that the investors could not have been equally responsible for the injury they suffered as a result of this fraudulent scheme. Therefore, the complaint should not have been dismissed on the basis of in pari delicto."

Pet. App. A-6, Opinion.

SUMMARY OF ARGUMENT

Bateman Eichler has presented three questions for this Court to consider but they can be summarized as only two: (1) does the common law in pari delicto defense apply to implied private anti-fraud actions under the federal securities laws and (2) if so, are the plaintiffs barred from proceeding with such an action because as "admitted tippee-securities law violators" they are

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"substantially equal" in fault to the defendants.

Plaintiffs' answer to the first question is that to date no circuit court, including the Ninth Circuit, 7/ has said that it does not apply. Thus, a substantial part of Bateman Eichler's argument 8/ is really not relevant to this Court's review of the Ninth Circuit decision because it considered in pari delicto as a possible defense in implied private actions under Section 10(b) of the Exchange Act.

However, plaintiffs respectfully submit that after this Court's decisions

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7/ Plaintiffs did argue in the Ninth Circuit that the court should reject the in pari delicto defense in Section 10(b) cases as a matter of enforcement policy but the Ninth Circuit's holding did not go that far.

8/ Brief of Petitioner at 18-43.

in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), Chiarella v. United States, 445 U.S. 222 (1980) and Dirks v. S.E.C., 463 U.S. 646, 103 S.Ct. 3255 (1983) the question of whether in pari delicto is an available defense in an action brought under Section 10(b) of the Exchange Act by a "tippee" against his "tipper" has been rendered moot. If the basis of the claim is a negligent misrepresentation it is no longer actionable and if the basis of the claim is an intentional misrepresentation the "tippee" has no duty to disclose false information, the breach of which would make him in pari delicto.

Even assuming a duty to disclose false information, however, plaintiffs' answer to the second issue is that a duped investor is never in pari delicto with someone who, from the outset, is intentionally defrauding him.

Finally, if such parties could be considered in pari delicto this Court should determine that public policy considerations with respect to protection and enforcement objectives for the federal securities laws militate against permitting the defense.

ARGUMENT

I. There Is No Need for an In Pari Delicto Defense in an Action Brought by a "Tippee" Against His "Tipper" Under the Antifraud Provision of the Federal Securities Laws.

This case, like the majority of the cases that have considered the question of whether the doctrine of in pari delicto provides a defense to an action under Section 10(b) of the Exchange Act, involves alleged "tippees" seeking to recover their trading losses from their "tippers" because the tip proved to be false.

Prior to this Court's decision in Ernst & Ernst no distinction was made between negligent and intentional conduct with respect to a false representation. Without such a distinction application of the in pari delicto doctrine was the only way to give consideration to transactions where a "tip" proved to be wrong but the "tipper" did not intentionally provide false information to his "tippee". Under these circumstances, the doctrine of in pari delicto would generally provide a defense because the "tipper's" and "tippee's" conduct could be viewed as "clearly mutual, simultaneous, and relatively equal". 9/

9/ Woolf v. S.D. Cohn & Co., 521 F.2d 225, 227 (5th Cir. 1975), citing James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974).

But, such a defense is no longer necessary because the conduct of the "tipper" is no longer actionable unless he has acted with the requisite degree of scienter required by Ernst & Ernst. 10/

It is under circumstances where the "tip" proves to be intentionally false that consideration of in pari delicto as a defense has presented more difficulty to the courts. And, it is the cases of intentional misrepresentation between "tipper" and "tippee" where the courts have split in determining whether the

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10/ Cf. discussion in Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1048 (7th Cir.), cert. denied, 434 U.S. 875 (1977) and Holdsworth v. Strong 545 F.2d 687 (10th Cir. 1976) admitting the weakening of the due diligence defense because of Ernst & Ernst's scienter requirement.

parties are in pari delicto. 11/ However, this Court need not consider whether the Ninth Circuit's determination that it would not find plaintiffs and their broker who intentionally provided false information in pari delicto as a matter of law or the Third Circuit's determination that it would is correct.

Just as the Ernst & Ernst decision has eliminated the relevance of an in pari delicto defense in actions under Section 10(b) of the Exchange Act where

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11/ Plaintiffs contend that the Ninth Circuit's decision that a "tippee" to whom a broker defendant is alleged and proved to have intentionally provided false information cannot be in pari delicto as a matter of law is in total harmony with the common law in pari delicto standard of requiring "clearly mutual, simultaneous and relatively equal" conduct. The conclusion that a person who is being deliberately provided a false "tip" is not involved in "mutual and simultaneous" conduct with the "tipper" seems obvious.

the information is not intentionally false, it is respectfully submitted that the Chiarella and Dirks decisions have eliminated the relevance of an in pari delicto defense in actions under Section 10(b) of the Exchange Act where the information is intentionally false.

In Chiarella, this Court held that the mere possession and use of non-public information does not result in liability under Section 10(b) of the Exchange Act in the absence of a corresponding duty to disclose the information. 445 U.S. 222, 231 (1980). In Dirks, this Court held that the existence of a duty for an alleged "tippee" was derivative from the duty owed by an "insider" to disclose the non-public information to those with whom he had a fiduciary relationship, i.e. the shareholders. 103 S.Ct. 3255, 3264 (1983).

Logic dictates that an insider cannot have a duty to disclose to his shareholders information which he knows to be false. Thus, the "tippee" who receives intentionally false information from an insider would have no derivative duty to disclose and could not violate the anti-fraud provisions of the securities laws with his attempted "inside trading". It would be a "legal impossibility" in the same sense as Bateman Eichler acknowledges existed in Silverberg and Xaphes v. Shearson, Hayden, Stone, Inc., 508 F.Supp. 882 (S.D. Fla. 1981). (Brief of Petitioner at 17, n.12.) 12/

Bateman Eichler urges this Court to conclude that application of its

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12/ See Notes, The Availability of the In Pari Delicto Defense in Tippee-Tipper Rule 10b-5 Actions After Dirks v. SEC, 62 Wash. U. L.Q. 519, 538-543 (1984).

decisions in Chiarella and Dirks to plaintiffs' conduct only requires a determination that plaintiffs knew that the "tip" came from an "insider" and that the "tip" was for an improper purpose, i.e., "pecuniary gain or a reputational benefit that will translate into future earnings", Dirks, 103 S.Ct. at 3265-66, and that therefore there was a duty to disclose.

This analysis reduces the duty to disclose to nothing more than an abstract concept. Plaintiffs do not believe this Court intended to define the duty to disclose with respect to possible violations of Section 10(b) of the Exchange Act arising out of the use of non-public information as a mere abstraction. The duty to disclose that the "insider" has must relate to specific information and it is impossible to see how there can be

a legal duty on the "insider" to disclose false information.

If this Court accepts Bateman Eichler's analysis and concludes that it is only necessary to find an "insider" duty to disclose in the abstract, the result will be that every insider will have carte blanche to defraud investors by inducing them to trade in securities with intentionally false tips. 13/ Such a result would be unconscionable and could not have been intended.

13/ If the insider provides intentionally false tips to an investor there could be little doubt that it would be for an "improper purpose" thereby satisfying the Dirks criterion and there would be no doubt that there would be a duty to disclose because the information would be coming from a known insider.

II. If a "Tippee" Receives Intentionally False Information In Pari Delicto Cannot Defeat His Claim Against His "Tipper" Because Their Conduct Is Not Mutual, Simultaneous and Relatively Equal.

Both Kuehnert v. Texstar Corporation, 412 F.2d 700 (5th Cir. 1969), and Malamphy v. Real-Tex Enterprises, Inc., 527 F.2d 978 (4th Cir. 1975), which Bateman Eichler contends supports its position, were decided before Ernst & Ernst. Thus, neither court was in the position to conclude as did the Ninth Circuit that scienter, if proved, would be inconsistent with the notion of "equal" fault. (Pet. App. A-10, n.2, Opinion.)

Moreover, neither the Fourth Circuit nor the Fifth Circuit have concluded that in pari delicto should be an absolute defense in a securities case without a

balancing of the relative fault of the parties. 14/

Silverberg v. Paine, Webber, Jackson & Curtis, Inc., 710 F.2d 678 (11th Cir. 1983), and Tarasi v. Pittsburg Nat'l Bank, 555 F.2d 1152 (3d Cir. 1977), were both decided after Ernst & Ernst. But, far from being in conflict with the decision of the Ninth Circuit herein, the decision by the Eleventh Circuit in Silverberg would appear to be completely consistent with the Ninth Circuit's conclusion that the defense of in pari

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14/ In Malamphy, the Fourth Circuit only concluded that it was not error to submit the defense of in pari delicto to the jury given the facts of the case. The Fifth Circuit's decision in Kuehnert has been clarified in two later cases -- James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974) and Woolf v. S.D. Cohn & Co., 521 F.2d 225 (5th Cir. 1975) -- both of which adopt the standard of "clearly mutual, simultaneous and relatively equal" conduct for the defense of in pari delicto to be available.

delicto is inappropriate "unless the alleged facts show that the investor is equally responsible for his injury". (Pet. App. A-11, Opinion.) That is precisely what the Eleventh Circuit decided when it concluded that the facts before the court did not warrant giving an in pari delicto jury instruction. A comparison of the facts presented in Silverberg to the allegations of the plaintiffs' complaint demonstrates that they did not act any more culpably than Dr. Silverberg. 15/

15/ Bateman Eichler justifies the conclusion reached by the Eleventh Circuit in Silverberg by stating that because no insider was involved Silberberg had no Chiarella/Dirks duty to disclose. Plaintiffs do not dispute this conclusion and as is discussed above respectfully submit neither do they have such a duty. Nevertheless, the similarity of the fraud perpetrated on Silverberg to the fraud perpetrated on plaintiffs is striking.

The Third Circuit actually recognized that under the Ernst & Ernst decision the absence of an in pari delicto defense would have the greatest impact "on deliberate purveyors of false information", Tarasi, 555 F.2d at 1163, but in adopting its equal fault standard, concluded that the conduct involved was in the nature of "equal fault" when considered in light of this Court's discussion of "passive" or "coerced" conduct in Perma Life. 555 F.2d at 1162. The conclusion of the Third Circuit that "equal" fault existed in Tarasi must have resulted more from a narrow construction of the holding of Perma Life than an actual determination that the conduct of the parties was "mutual and simultaneous".

It is respectfully submitted that the common law doctrine which requires "clearly mutual, simultaneous and

relatively equal" conduct to sustain in pari delicto has not been modified by Perma Life to mean only non-passive and non-coerced conduct. A person who is deliberately duped simply cannot be said to be in pari delicto with "deliberate purveyors of false information".

III. The In Pari Delicto Defense Should Not Be Available to a Broker Defendant in a Section 10(b) Case.

A. The Enforcement Standard Articulated in Perma Life Mufflers, Inc. v. International Parts Co., 392 U.S. 134 (1968), Should Be Applied to Conduct of Broker Defendants in Circumstances of Equal Fault With Their "Tippees".

Although this Court has not ruled on the precise question of law, it has ruled on the application of the in pari delicto defense in the context of a federal regulatory scheme and private actions arising out of the federal regulations. It is respectfully submitted that the majority opinion in Perma Life Mufflers, Inc. v.

International Parts Corp., 392 U.S. 134 (1968), eliminated the application of the defense to private antitrust actions. 392 U.S. at 140. Simultaneous with the elimination of the defense was the adoption of a new standard for permitting recovery in circumstances of equal fault. 16/ As Justice Black explained:

> "We have often indicated the inappropriateness of invoking broad common law barriers to relief where a private suit serves important public purposes. . . . A more fastidious regard for the relative moral worth of the parties would only result in seriously undermining the usefulness of the private action as a bulwark of antitrust enforcement."

392 U.S. at 138.

16/ In Perma Life this Court actually found that on the facts the parties were not of "equal fault" because the plaintiffs had a weaker bargaining position and were coerced into accepting the overall contractual scheme. 392 U.S. at 139.

Most of the courts which have considered the in pari delicto defense in the context of a securities case have addressed the issue of whether this Court's Perma Life holding should be extended to the federal securities laws regulatory scheme. None of the courts, including the Ninth Circuit, have embraced the notion that the defense should be eliminated entirely. 17/ However, all of these courts have balanced some consideration of the so-called

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17/ As is argued above total elimination of the defense in the context of a case under Section 10(b) of the Exchange Act may already have been accomplished through narrowing of the scope of activity condemned and the scope of the duty to disclose with respect to the use of non-public information and identifying the derivative nature of the "tippee's" duty to disclose.

enforcement standard articulated by Justice Black. 18/

Thus in Tarsai, the Third Circuit interpreted its task in assessing the availability of in pari delicto as follows:

> "Perma Life thus appears to have restricted consideration of plaintiffs' illegal conduct as a defense without foreclosing cognizance of this factor altogether. A plaintiff's unlawful conduct must be

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18/ Bateman Eichler appears to suggest that any consideration of an enforcement standard is improper because the private right of action under the antifraud provisions of the securities laws is implied rather than statutory. The goal of preventing common law barriers to relief in a private suit which serves the important public purpose of a "bulwark" of enforcement is not different simply because the private action is specifically provided for in one regulatory scheme and judicially inferred in another. If anything, the public policy which sustains the inference of a private action for needed enforcement of the regulatory scheme would seem more likely to compel private action enforcement which is unfettered.

> active and significant before it can bar a verdict in his favor. However, Perma Life also teaches that prevention of unjust enrichment and protection of the integrity of the courts cannot, by themselves, thwart recovery in private actions under regulatory statutes. Accordingly, before denying recovery to a plaintiff, a court must carefully assess the impact of such a result on the enforcement of statutory schemes. [Footnote omitted.] This we shall now proceed to do."

555 F.2d at 1158-59.

And in Kuehnert, the Fifth Circuit held:

> "Although Kuehnert's status as a tippee makes the defenses of unclean hands and in pari delicto available, their application rests with the discretion of the court. [Citation omitted.] The question must be one of policy: which decision will have the better consequences in promoting the objective of the securities laws by increasing the protection to be afforded the investing public. [Citation omitted.]"

412 F.2d at 704.

All of the courts have recognized the need to apply an enforcement standard to some extent in analyzing the availability of in pari delicto. The only real question has been what is the proper policy to pursue regarding enforcement with respect to "tippers" and "tippees".

B. Protection and Enforcement of the Federal Securities Regulatory Scheme Is Best Served by Elimination of In Pari Delicto As a Defense Between a Broker Defendant Acting As a "Tipper" and His "Tippee".

Bateman Eichler contends that the Third and Fifth Circuits' analysis of the enforcement policy considerations is superior to that of the Ninth Circuit. 19/

The Ninth Circuit analyzed the enforcement policy issue at three levels: (1) it adopted an approach consistent

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19/ Brief of Petitioner at 10-11, 35-40.

with the Perma Life case's focus first on the deterrent effect on the defendant as opposed to a focus on what would encourage plaintiffs' compliance (Pet. App. A-8, Opinion); (2) it concluded that the compliance effect on plaintiffs was outweighed by resulting adverse consequences to the market and innocent investors (Pet. App. A-9, Opinion); and (3) it recognized the absence of any absolute warranty ("heads I win, tails you lose") 20/ with respect to a "tip" in light of the exclusion of innocent or negligent misrepresentation from actionable claims under Section 10(b) of the Exchange Act

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20/ The only warranty the"tippee" receives is that no intentional misrepresentations will be made to him. Contrast this to the warranty an insider receives in the presence of the in pari delicto defense -- he may attempt to defraud with absolute and total impunity against a private civil action. See discussion in part I above.

after Ernst & Ernst. (Pet. App. A-10, Opinion.)

The courts in the cases relied upon by Bateman Eichler have concluded that enforcement is best served by a balance of sanctions between "tipper" and "tippee" and contend that there are adequate statutory deterrents to "tippers". The theory is that these deterrents will come into play because the "tippers" are "highly visible" whereas the "tippees" are not.

> "Elimination of the defense would remove the most effective disincentive against the 'tippee's' use of inside information. Because of the tippee's relatively low visibility, the threat of discovery and potential liability is slight. By contrast, 'tippers' are usually highly visible officers, directors or brokerage firms, subject to extensive statutory disclosure requirements, SEC enforcement actions and private

> suits by non-'tippee' purchasers or sellers."

In re Haven Industries, Inc., 462 F.Supp. 172, 180 (S.D.N.Y. 1978). 21/

There are two essential fallacies in an analysis which concludes that the

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21/ The difference between Judge Gagliardi's approach to enforcement policy and the Ninth Circuit's exemplifies the only real difference between the cases which allow the in pari delicto defense and those which deny it. Those cases allowing the defense focus upon deterring the tippee from taking a tip. Those cases denying the defense focus upon deterring the tipper from giving the tip. Numerous commentators have discussed this essential difference and have concluded that the proper focus is on deterring the giving of the tip. See, Comments, Rule 10b-5: The In Pari Delicto and Unclean Hands Defenses, 58 Calif. L.R. 1149, 1159-60 (1970); Schiebelhut, The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes, 60 Calif. L.R. 531 (1972); Comments, Availability of an In Pari Delicto Defense in Rule 10b-5 Tippee Suits, 77 Col. L.R. 1084, 1097 (1977); Murray, Securities Regulation - In Pari Delicto as a Bar to Private Antifraud Action by Tippee Against Tipper, 43 Mo. L.R. 378, 386-387 (1978).

deterrent effect must be placed upon the taker of the tip in order to equalize or maximize the possible deterrent effect on both the "tipper" and the "tippee". The first fallacy is that the "tipper" has himself necessarily acted upon the information in the tip and therefore is "highly visible" and subject to discovery through other types of proceedings. The second fallacy is that "tippees" respond to the deterrent effect of not being able to recover on a false tip. Two simple illustrative scenarios demonstrate these fallacies.

Assume that a "tippee" receives a true tip from a corporate insider. The "tippee" then goes to his broker and either purchases or sells depending on the tip. A member of the investing public without the tip suffers a loss in the transaction. The "tippee" makes an

illegal profit and because of his alleged remoteness [from the insider group] he goes undetected. Query: how is the "tipper" in this transaction "detected" so that the so-called "substantial deterrents to 'tippers' . . . in the form of SEC and criminal actions as well as private suits by non-'tippee' purchasers and sellers who have been adversely affected" (In re Haven Industries, Inc., 426 F.Supp. at. 180) come into play? The insider has not engaged in any transaction which identifies him. Surely we are not to assume that the "tipper" has announced to the world that he illegally gave a tip. In fact, the only link the insider has to any wrongdoing which could trigge. either governmental investigation or a private suit by the injured non-tippee is through the "tippee", who according to the theory is difficult to

discover. Thus, when an insider gives a true tip and does nothing further, he is probably more remote than his "tippee" in terms of discovery.

Even if the insider "tipper" actually trades in the stock, and therefore might truly be said to be highly visible, and, in fact, is actually identified, there is certainly no reason to believe that the investigation (either public or private) cannot go one step further with the insider identifying those people to whom he gave his information.

Now assume that a "tippee" receives a false tip from a corporate insider. The "tippee" then goes to his broker and either purchases or sells depending on the tip. A member of the investing public without the tip suffers no loss in the transaction. In fact, the "tippee" suffers a loss. Both the "tipper" and

the "tippee" are alleged to have violated the law but the entire transaction goes undetected. Understandably the "tipper" has no incentive to inform the governmental regulators that recent activity in his corporation's stock resulted from false tips he disseminated. And, if the "tippee" is precluded from asserting a claim for his damages, he has no incentive to inform the regulators about the tip. In fact, the very reason the "tippee" is being denied the right to assert his claim -- his own conduct is illegal under the securities laws -- assures that the "tippee" will not advise anyone of the transaction. 22/

22/ As one commentator suggests:

"A plaintiff who may be at fault to some degree cannot be expected to assume the expense of

[FN. CONT'D. ON FOLLOWING PAGE]

Significantly, however, although the individual members of the investing public who trade with the "tippee" with false information suffer no individual damages, the market for the stock has been adversely impacted and members of the investing public generally may suffer damage because they are trading in a stock the market for which has been artificially manipulated. This, of course, is one of the principal abuses which the Exchange Act sought to prevent by Section 10(b).

> bringing an action and the risk of exposing himself to potential liability unless there is a strong indication that the law will offer the appropriate encouragement by barring the [in pari delicto and unclean hands] defenses."

Comments, Rule 10b-5: The In Pari Delicto and Unclean Hands Defenses, supra, at 1158.

Moreover, the only way the so-called deterrent effect of denying recovery to the "tippee" can possibly discourage the taking of a tip, is if it is assumed that most "tippees" approach the tip assuming it is false. Under the reasoning of the courts permitting the defense, if the "tippees" believe the tip is true they believe they are "remote" in terms of discovery.

Suffice to say that notwithstanding their broker and insider status the SEC does not view these "tippers" as "highly visible" and that is one of the reasons it believes that the defense of in pari delicto should not be permitted to discourage "tippee" suits.

Bateman Eichler contends that the investor "tippee" is at least equally culpable with the scheming broker or corporate insider because the investor is

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the very person who directly causes the damage to the securities markets. The answer is that there will be no takers of tips if there are no tips. The opposite is not true. And, if brokers and corporate insiders are protected by the doctrine of in pari delicto even when they disseminate deliberately false tips to manipulate the market, an abundance of such tips will always exist in the hopes that some unsuspecting investors will appear.

CONCLUSION

Bateman Eichler has attempted to make the Ninth Circuit decision appear reckless, poorly reasoned and in conflict with both common law and the majority of case law. It is respectfully submitted that the decision stands up to all of these attacks. Moreover, the decision reaches the result which this Court's

decisions in Ernst & Ernst, Dirks and Chiarella support. Respondents respectfully pray that the judgment of the Ninth Circuit be affirmed.

Dated: March 27, 1985

Respectfully submitted,

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AFFIDAVIT OF SERVICE BY MAIL

State of California)
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Josie Strupaitis, being first duly sworn upon oath, deposes and says:

That affiant is a citizen of the United States, over 18 years of age, and not a party to the within cause; that affiant's business address is 862 Folsom Street, San Francisco, California 94107; that affiant served three (3) true and correct copies of the attached **Brief For Respondents** on each of the following persons, by placing same in envelopes addressed as follows:

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that said envelopes were then, on March 27, 1985, sealed and deposited in the United States Mail at San Francisco, California, with the postage thereon fully prepaid; and that there is delivery service by United States Mail at the place so addressed, or that there is regular communication by mail between the place of mailing and the place so addressed.

Jean Stuppitis

Subscribed and sworn to
before me this 27th day
of March, 1985

Arthur L. Martin

Notary Public in and for
the City and County of
San Francisco, State of
California

ARTHUR L. MARTIN
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My Commission Expires December 26, 1986

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No. 84-679

In the Supreme Court
OF THE
United States

OCTOBER TERM 1984

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED
Petitioner,

VS.

CARL F. BERNER, CHARLES BRUNER, DENNIS T. DEMETRE, LAWRENCE EPSTEIN, BARRY S. GLASS, HERBERT GREENBAUM, ROBERT M. JACOBS, ARNOLD R. KEILES, HARRY MITTLEMAN, GARY L. NOBEL, CHARLES P. LAZZARO, LESLIE L. NEADEAU and T.O.N.M OIL & GAS EXPLORATION CORPORATION,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF OF PETITIONER

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REPLY BRIEF OF PETITIONER

INTRODUCTION AND SUMMARY OF ARGUMENT

Respondents' brief argues that the defense of *in pari delicto* should never be available in private federal securities fraud actions by tippees against tippers. No court ever has endorsed this absolutist view, which ignores entirely the judicial integrity, deterrence and public policy considerations that underlie the more than two hundred year history of the defense. Petitioner's

opening brief ("Pet. Br.") develops fully the factors warranting availability of the defense in such actions and, in so doing, anticipates Respondents' arguments. Petitioner accordingly does not cover that ground again here but instead focuses upon the arguments of the Securities and Exchange Commission ("SEC").

The SEC seeks to support denial of the defense by repeatedly, but erroneously, insisting that its present prosecutorial enforcement position is somehow a congressional policy which warrants overriding the *in pari delicto* defense. No such congressional policy exists. The SEC's surprising depiction of defrauder tippees as relatively benign investors demands response, as well, as do the SEC's conclusory assertions with respect to deterrence.[1]

The bulk of the SEC's position, however, is entirely consistent with Petitioner's. The SEC does not take issue with the fundamental precepts upon which Petitioner bases its conclusion that the defense of *in pari delicto* is available to the broker and broker-dealer under the circumstances that the complaint presents.

The SEC concedes that courts should approve application of the *in pari delicto* defense to some private 10b-5 claims (SEC Br. 6-7), and it recognizes that this Court's decision in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), does not preclude use of the defense in securities fraud actions (SEC Br. 6-7, 12-16). Moreover, the SEC acknowledges that the common law contours of the *in pari delicto* defense guide its application to a tippee-tipper lawsuit. (SEC Br. 9-12, 15-16). The SEC further agrees that principles of judicial integrity and deterrence are the cornerstones for the defense.

[1] Petitioner already has anticipated and taken issue with the SEC's general analysis of deterrence as it applies to cases involving broker-dealers. (Pet. Br. 35-43). However, the SEC's further deterrence analysis in its amicus brief, built as it is entirely upon conjecture, requires additional response. This response appears, *infra*, at 10-12.

(For understandable reasons, however, the SEC buries acknowledgment of the former in a footnote, SEC Br. 26 n.31, and nowhere else explains how the judicial system could avoid suffering damage to its integrity from permitting wrongdoing plaintiffs to recoup their losses.)[2]

Thus, the SEC recognizes that courts should apply the *in pari delicto* defense where plaintiff's fault is substantially equal to defendant's and agrees that the mere fact that a defendant is a securities broker does not itself bar invocation of the defense. Indeed, the SEC advises that:

> The Commission believes that a securities professional should be permitted to invoke the common law *in pari delicto* defense only where the plaintiff's fault is, in fact, substantially equal to or greater than his own—for example, where the plaintiff was involved in an actual conspiracy with the professional to misuse inside information for their mutual benefit. . . .

(SEC Br. 7).

[2] In its footnote 31, the SEC attempts to convince this Court that authorizing suits by tippee-wrongdoers will not undermine public confidence in the judicial process. The SEC does so by arguing based upon its own *ipse dixit* that tippee traders are less blameworthy than tipper brokers and that encouragement of recompense for the tippees' losses furthers the purposes of the securities laws. Petitioner takes issue with each of those contentions. (Reply, *infra*, at 10-12). The SEC then suggests that Congress' express authorization for contribution in Section 9(e) of Securities Exchange Act of 1934, 15 U.S.C. § 78i(e), demonstrates Congress' view that suits by securities manipulators for contribution under that Section would not undermine judicial integrity. To the contrary, the Section reveals Congress' value judgment in the context of Section 9(e) (a similar value judgment appears in Section 18(b) of the Securities Exchange Act, 15 U.S.C. § 78r(b), and Section 11(f) of the Securities Act, 15 U.S.C. § 77k(f) that a right of contribution would effectuate Congress' purposes under those sections of the securities laws because it enlarges the group of wrongdoers penalized for the misconduct causing the loss. The SEC's position does not accomplish these goals. Rather, it would enable one wrongdoer to shift all loss to the other.

Petitioner agrees that the defense should apply in the SEC's chosen example. The case at bar is such a case.

The SEC parts company with the Petitioner, however, when the SEC endeavors to paint a picture of plaintiffs, admitted tippee traders, as parties whom courts applying the securities laws should protect. The effort disregards entirely the harm that such condoning of unlawful conduct would inflict on the judicial system. It sanctions a result which would use the courts to permit recovery of all losses that securities law violators incur because of their attempts to defraud innocent investors.

The SEC's ultimate conclusion rejecting the defense also depends upon a series of predicates for inequality which submerge the knowing misconduct of the respondent plaintiffs and escalate the delict of the broker merely because of his status as such. But the SEC's posited substantially greater fault of the broker is insupportable for the following reasons: (1) the complaint establishes that plaintiffs confirmed with a corporate insider their possession of non-public information on which they should not trade; (2) the provisions of the securities laws relied upon by plaintiffs make no distinction whatever between the conduct of brokers and "any [other] person," and the SEC must look to Congress, not to this Court, for the creation of special duties of brokers under the securities provisions at issue; (3) while the broker who passes on inside information to trading tippees interacts with the guilty, those wrongful tippees defraud the innocent; (4) a broker's fiduciary duty to his client, if any, is no different from the tippee's fiduciary duty under *Dirks v. SEC*, ___ U.S. ___, 103, S. Ct. 3255 (1983), to shareholders who are not privy to his tip; and (5) a tippee's derivative duty under *Dirks* is a duty which he breaches only by his own direct, unlawful acts and thus does not result in liability without culpability.

ARGUMENT

1. The SEC's Culpability Analysis Refuses to Recognize the Allegations of the Complaint Establishing Plaintiffs' Liability for Knowing Securities Fraud

The detailed allegations of the Complaint establish that plaintiffs purchased T.O.N.M. stock because the broker told certain of the plaintiffs that he knew T.O.N.M.'s president and/or vice president personally and had learned material non-public information about the company that, upon publication, would cause a dramatic increase in the value of T.O.N.M. stock. Plaintiffs traded expressly "on the premise" that the information Lazzaro gave them was "information not otherwise available to the general public." (Jt. App. 10).[3] Acting nothing like the innocent dupes that the SEC and plaintiffs paint, the tippees went directly to T.O.N.M. president Leslie Neadeau to verify the accuracy of their tips. Neadeau advised them explicitly that the tips "were not public knowledge and that plaintiffs would have to wait for the publication of TONM's annual report." (Jt. App. 12). Plaintiffs thus learned from the highest corporate insider possible that the information came to them as the result of a breach of duty, that is, via someone who was not supposed

[3] As Petitioner explained in its opening brief (Pet. Br. 15-18) and as the SEC concedes (SEC Br. 17-18), it is immaterial, for purposes of analysis of plaintiffs' violations, whether plaintiffs actually received inside information (as Petitioner contends they did (Pet. Br. 15-16)) or whether plaintiffs instead merely believed that they had received such information. Plaintiffs' failure to recognize this point vitiates their argument (Resp. Br. 10-18) that this Court's requirement of scienter in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), somehow prevents the existence of a violation by the tippees. Because the analysis of the tippees' conduct must proceed from the standpoint of what tippees *believed* to be the operative facts, plaintiffs' factual impossibility argument fails to save them. The tippees' duty to disclose arises not from the truth or falsity of the inside information but from the tippees' belief as to its truth. Similarly, the alleged falsity of the information cannot deprive it of materiality, as the SEC lightly suggests despite its recognition of the applicability of attempt theory (SEC Br. 17).

to disseminate information available at that moment only for corporate purposes and not for personal use or benefit (*Dirks*, 103 S. Ct. at 3261). Plaintiffs also knew that if they acted upon the information, they would have an unfair and unlawful advantage over the other parties to their trades. In addition, plaintiffs obtained from Neadeau "winking" confirmation of the accuracy of the tips, when Neadeau told them that their source was "very trustworthy and a good man" (Jt. App. 12).

In disregard of these facts, the SEC suggests that plaintiffs may not have known that the tips came from an insider with a duty not to disclose the information.[4] Surely no notice short of a flashing neon sign could be more sufficient. Neadeau not only confirmed that the information was "inside" information, but he also made it absolutely clear that plaintiffs were not supposed to trade on that information. This fact renders irrelevant the SEC's "ignorance of the law" suggestion, which would not be a defense in any event. (SEC Br. 20). Thus plaintiffs are not merely technical transgressors who received information to which they believed themselves legitimately entitled. Plaintiffs

[4] The SEC's position apparently would find a violation by a tippee only in a situation where the tipper sat down with the tippee and provided him with secret corporate information, told the tippee it was wrong to give him this information, and then asked him to trade on that information and secretly pass some of his profits to the corporate insider. The Commission has not so constricted its view of unlawful tippee trading in cases post-*Dirks* where it has prosecuted tippees. *See, e.g., United States v. Reed*, No. 84-CR 610, slip op. at 10-11, 17 (S.D.N.Y. Jan. 24, 1985) (available April 5, 1985 on Lexis); *Securities and Exchange Commission v. Thayer*, No. 84-CIV 66 (S.D.N.Y. 1984). *See generally Securities and Exchange Commission v. Musella*, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,637 (S.D.N.Y. 1984) (misappropriation); *Securities and Exchange Commission v. Materia*, 745 F.2d 197 (2d Cir. 1984) (misappropriation); *Securities and Exchange Commission v. Lund*, 570 F.Supp. 1397 (C.D. Cal. 1983) (temporary insider).

instead are knowing defrauders, and defendants' alleged fraud cannot excuse theirs.[5]

[5] A plaintiff does not regain the right to recover by charging that his co-conspirator defrauded him. *McMullen v. Hoffman*, 174 U.S. 639 (1898) (no relief among conspirators to defraud in bidding on a public contract); *Collins v. Pioneer Title Insurance Co.*, 629 F.2d 429, 434 (6th Cir. 1980) (plaintiff barred from suing co-conspirator after fraudulently obtaining policy of title insurance); *Ford v. Caspers*, 128 F.2d 884, 885 (7th Cir. 1942) (relief denied against co-conspirator in fraudulent conveyances); 6A *Corbin on Contracts*, § 1536 at 823 (1962) ("Ordinarily one who participates in a conspiracy to defraud third persons is regarded as morally delinquent and not entitled to restitution from another participant."). Rather, relief from application of *in pari delicto* on grounds of fraud is usually reserved for cases where plaintiff is free of fraudulent intent and thus, in fact, is not substantially equal in fault. This exception arises where plaintiff is involved in acts merely *mala prohibita*, *see In re E. J. Arnold & Co.*, 33 F. 789 (E.D. Mo. (1904) (gambling); *Lockman v. Cobb*, 77 Ark. 279, 91 S.W. 546 (1905) (gambling); *Webb v. Fulchire*, 25 N.C. 485 (1843) (gambling); *Hess v. Culver*, 77 Mich. 598, 43 N.W. 994 (1889) (improper dealing with corporation); *Grim v. Cheatwood*, 208 Okla. 570, 257 P.2d 1049 (1953) (gambling), or where plaintiff does not know of the underlying wrongfulness, *National Bank & Loan Co. v. Petrie*, 189 U.S. 423, 424 (1903) (sale of bonds where plaintiff did not know that bank had not authorized transaction).

Where, as here, the plaintiff has deliberately set upon a fraudulent course in concert with defendant, courts will not "draw fine distinction in ascertaining equality of wrong." *See Hess v. Culver*, 77 Mich. 598, 43 N.W. 994 (1889). Relief will be denied unless there is evidence of coercion, oppression, frailty, naivete or other great inequality of condition such that plaintiff did not exercise a "deliberate judgment" to defraud, *see Gorringe v. Reed*, 23 Utah 120, 131, 63 P. 902, 905 (1901) (relief from transaction under duress of threatened criminal prosecution and imprisonment); *Rozell v. Vansyckle*, 11 Wash. 79, 87, 39 P. 270, 273 (1895) (relief available to cancel conveyances by aged man in reliance on defendants' advice); *Barnes v. Brown*, 32 Mich. 146, 148 (1875) (great disparity in business acuity justified rescission of deeds conveyed on defendant's trusted advice); *Harrety v. Kontos*, 238 Mo. App. 519, 184 S.W. 2d 195 (1944) (same); 3 J. Pomeroy, *A Treatise on Equity Jurisprudence* §§ 942-944, 947-948, 948a, 950a, at 738-774 (5th ed. 1941). *See also Jewel Tea Co. v. Local Unions, etc.*, 274 F.2d 217 (7th Cir.), *cert. denied*, 362 U.S. 936 (1960) (*in pari delicto* defense not applied against plaintiff whose antitrust violation was induced by economic necessity); *Peter v. Western Newspaper Union*, 200 F.2d 867 (5th Cir. 1953) (stockholder who, under economic duress, sold his shares in violation of antitrust laws not *in pari delicto*).

Petitioner agrees with the SEC that a comparison of the relative fault of the parties is not based upon "a neat calculus." (SEC Br. at 10 (quoting *Golberg v. Sanglier*, 96 Wash. 2d 874, 883, 639 P.2d 1347, 1353 (1982))). In fact, Petitioner asserts that courts should not use jewelers' balances in order to perform *in pari delicto* substantial equality calculations. Courts instead must decide only (1) whether plaintiff's conduct crosses a threshold of seriousness required to justify barring their claims and (2) whether exceptions for coercion, duress,[6] or congressional elevation of statutory claims over common law defenses apply. Plaintiffs' conduct outlined above is more than sufficiently egregious to bar their claims, and none of the exceptions to the doctrine is applicable. For the SEC to whitewash those violations and to present seemingly insuperable burdens to the establishment of tippee liability is a curious role, indeed, for the agency charged with enforcement of the federal securities laws. The SEC apparently takes this posture because of the result it now seeks from this Court, while at the same time it hopes to preserve for a later day the option to contend that plaintiffs in fact are tippees who violated 10b-5.

2. The SEC's Arguments Seeking to Create a Higher Duty for Brokers Than for Tippees Do Not Find Support in the Securities Provisions in Issue.

Another of the SEC's efforts to avoid substantial equality of fault centers on the argument that the broker is more culpable than his tippees because the broker is a "securities professional." (SEC Br. 2, 7, 16, 21, 23). The SEC thus would have this Court create a new class of parties heretofore unknown to Section 10(b), Rule 10b-5, and Section 17(a). The argument apparently is that because Congress expressly regulated the activities of brokers and dealers in certain sections of the securities laws, it endorsed greater liability for brokers and dealers in the other sections of the securities laws where it

[6] *See* cases cited in footnote 5.

did not see fit to create standards for brokers and dealers different from those for "any [other] person." This Court has previously dispatched similar arguments by the SEC.[7]

The SEC also argues that a broker's culpability should be greater than a tippee's merely because a broker owes his customer a fiduciary duty. Any fiduciary duty that a broker owes his customers, however, is entirely beside the point in an analysis of substantial equality of culpability of a defrauding broker and defrauding tippee.[8] This analysis focuses upon conduct, not status. The existence of a fiduciary duty from a broker to his client has only a limited legal effect. The most significant aspect of this effect is the creation of an obligation to disclose facts that, absent the duty, he would be free to omit.[9] Thus, the duty may create a legal obligation where none otherwise would have existed, but it neither increases the

[7] In *Ernst & Ernst v. Hochfelder, supra*, 425 U.S. at 200-01, this Court rejected the SEC's arguments in favor of a negligence standard and, after citing three different standards of liability that Congress established in three different parts of the securities laws, noted:

> It is thus evident that Congress fashioned standards of fault in the express civil remedies in the 1933 and 1934 Acts on a particularized basis. Ascertainment of congressional intent with respect to the particular section of the Acts must therefore rest primarily on the language of that section. Where, as here, we deal with a judicially implied liability, the statutory language certainly is no less important.

425 U.S. at 200-01. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734 (1975) ("When Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly."). This Court has often observed that questions regarding Congress' intent require resort in the first instance to the language of the statute. *See, e.g., Ernst & Ernst v. Hochfelder, supra*, 425 U.S. at 197 ("In addressing this question, we turn first to the language of § 10(b), for '[t]he starting point in every case involving construction of a statute is the language itself.'") (quoting *Blue Chip Stamps v. Manor Drug Stores, supra*, 421 U.S. at 756).

[8] Even were there any merit to the SEC's argument, it would apply only to those plaintiffs who were customers of Lazzaro and not to the remaining plaintiffs. A careful reading of the Complaint reveals that not all plaintiffs were his customers.

[9] See Restatement (Second) of Torts § 551 (1977).

severity of an otherwise existing violation by a broker nor diminishes the severity of a customer's own violation. In any event, Plaintiffs' allegations against the broker here under the federal securities laws are not dependent upon the existence of fiduciary duty.

Even if fiduciary duty were relevant to the calculus that the SEC invites, the argument still could not save plaintiffs. They, too, breached a fiduciary duty — to the innocent parties on the other side of their trades. They "acquire[d this] fiduciary duty to disclose or abstain" when they learned inside information that they knew emanated from Neadeau's breach of his fiduciary duty to the corporation's shareholders. *Dirks v. SEC, supra,* 103 S. Ct. at 3265-66 n. 23. Nor is this duty lessened by the derivation of the tippees' breach of duty from that of Neadeau. The SEC's argument that derivative liability is less serious might have some merit when applied to vicarious liability (as, for example, when an employer who has committed no affirmative misconduct is held liable as a matter of law for misconduct of an employee). It has no applicability to a tippee who derives his duty from an insider but breaches that duty only by his own willful conduct.

3. Acceptance of the SEC's Position Would, as Noted by the Courts of Appeals of the Third and Fifth Circuits, Encourage Tippee Insider Trading.

The SEC's deterrence arguments deserve no special weight because they are based merely upon the SEC's speculations regarding the effect of the *in pari delicto* defense—speculations created to endorse the conclusions that the SEC advocates here.[10] In our view, the deterrence analysis by the Courts of

[10] This Court frequently has declined to give special weight to the SEC's views in situations where, as here, the SEC advocates a position on the ground that it serves the SEC's prosecutorial goals, but that position does not find support in the language of the securities laws. *See, e.g., International Brotherhood of Teamsters v. Daniel,* 439 U.S. 551, 566 (1979) ("[T]his

(Footnote continued on following page)

Appeals of the Third and Fifth Circuits in *Tarasi v. Pittsburgh National Bank,* 555 F.2d 1152 (3d Cir.), *cert. denied,* 434 U.S. 965 (1977); and *Kuehnert v. Texstar Corp.,* 412 F.2d 700 (5th Cir. 1969), is more persuasive. As those courts note, the focus upon tippers pays insufficient heed to the encouragement of tippee misconduct that the elimination of the defense would create. Barring the defense on the grounds that the SEC asserts would leave the tippee, who has learned inside information unlawfully, with virtually no downside risk. If the information is true, the tippee stands to profit, perhaps enormously, with only the slimmest chance of discovery and proof of the violation either by the SEC or by the other parties to his trades. If the information is intentionally false, he may sue his broker and recoup his losses.[11] Fear of prosecution by the SEC is not a

(Footnote continued from previous page)

deference is constrained by our obligation to honor the clear meaning of a statute, as revealed by its language, purpose and history. On a number of occasions in recent years this Court has found it necessary to reject the SEC's interpretation of various provisions of the Securities Act."); *Piper v. Chris-Craft Industries, Inc.,* 430 U.S. 1, 41 n. 27 1977) ("[The SEC's] presumed 'expertise' in the securities-law field is of limited value when the narrow legal issue is one peculiarly reserved for judicial resolution, namely whether a cause of action should be implied by judicial interpretation in favor of a particular class of litigants. Indeed, in our prior cases relating to implied causes of action, the Court has understandably not invoked the 'administrative deference' rule, even when the SEC supported the result reached in the particular case.")

[11] The SEC agrees with the conclusion of the Ninth Circuit Court of Appeals that the tippee's "warranty of accuracy" is imperfect because the tippee may not be able to recover his losses if the broker passes on information that the broker reasonably believes to be true but that later does not lead to the expected results. That the warranty may be thus limited, however, does not undermine is effect. The result that the SEC advocates still leaves the tippee with substantial encouragement to trade on inside information wrongfully obtained. The tippee deciding whether to act on that information would know that in two out of the three possible scenarios, he does not have to worry about losing his money. Even under the third scenario (of no broker scienter), he still may be able to bring suit under common law theories that employ a standard less rigorous than scienter.

realistic deterrent in "false tip" cases, because the SEC has not expressed any intent to prosecute recipients of false tips. Indeed, the SEC strains to purify plaintiffs' conduct here.

Contrast this situation with that the tipper faces. The SEC has at its disposal the very real remedies Petitioner cites (Pet. Br. 38 n. 31), and those remedies threaten the very livelihood of the brokers.[12] Moreover, the SEC and the self-regulatory agencies possess powers which permit relief against brokers without costly and time consuming resort to court process.[13] Hence, wrongdoing brokers know that swift justice awaits them.[14]

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[12] The elimination of wrongdoing tippees from the class of possible plaintiffs does not mean that no one is available to sue the tipper in a private action, either. The other parties to the tippees' trades who lose money as a result of the tippees' unfair informational advantage or as a result of the market effects of the tippees' trading may sue the tipper without bar, because those plaintiffs are not guilty of any misconduct.

[13] *See* 5C A. Jacobs, Litigation Practice Under Rule 10b-5 § 261.05 (2d ed. 1985) and authorities cited therein.

[14] If the SEC feels that its numerous enforcement remedies are insufficient and that brokers also should be deprived of common law defenses, the SEC should address its arguments to Congress, not to this Court. *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 156 n.12 (1976); *Mercantile National Bank v. Langdeau*, 371 U.S. 555, 563 (1963). To date, Congress has not expressed its desire to eliminate these defenses but instead has acquiesced in judicial recognition of common law defenses to federal securities law claims for more than forty years. *See, e.g.*, cases in Pet. Br. at 22-28, and the following additional cases dating as early as 1941: *Goldenberg v. Bache & Co.*, 270 F.2d 675, 681 (5th Cir. 1959) (plaintiff's claim barred by laches for failure to complain of facts of which plaintiff was aware); *Tobacco and Allied Stocks, Inc. v. Transamerica Corp.*, 143 F. Supp. 323, 327-28 (D. Del. 1956) (defendant allowed to assert laches if circumstances warrant), *aff'd*, 244 F.2d 902 (3d Cir. 1957); *Carr v. Warner*, 137 F. Supp. 611, 614-15 (D. Mass. 1955) (plaintiff's claim barred by waiver for failure to complain of facts of which plaintiff was aware); *Nash v. J. Arthur Warner & Co.*, 137 F. Supp. 615, 618 (D. Mass. 1955) (companion case to *Carr*); *Rosenberg v. Hano*, 121 F.2d 818, 821-22 (3d Cir. 1941) (plaintiff barred from recovery because of his lack of diligence in discovering fraud perpetrated against him); *see also Consolidated Engineering Corp. v. Nesbit*, 102 F. Supp. 112, 114 (S.D. Cal. 1951) (corporation estopped from recovering short swing profits).

CONCLUSION

For the reasons stated here as well as in Petitioner's opening brief, this Court should reverse the judgment of the United States Court of Appeals for the Ninth Circuit and enter a judgment dismissing this action and holding that plaintiffs' implied securities fraud claims are barred by the *in pari delicto* defense, because of plaintiffs' admitted violations of the very statutes they seek to assert against Petitioner.

Respectfully submitted,

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